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No. 08-

In the

# Supreme Court of the United States

*In re Merix Corporation Securities Litigation*

**MERIX CORPORATION, et al.,**
***Petitioners***

**v.**

**CENTRAL LABORERS PENSION FUND,**
***Respondent***

**On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit**

## PETITION FOR WRIT OF CERTIORARI

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September 22, 2008

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## QUESTIONS PRESENTED

1. Whether, in ruling on a motion to dismiss an amended pleading, a district court must give effect to factual allegations in the amended pleading even if they conflict with factual allegations of an earlier pleading.

2. Whether the "necessarily constitute fraud" standard used by the Ninth Circuit to determine if allegations in a complaint sound in fraud, and therefore are subject to the heightened pleading requirements of Federal Rule of Civil Procedure 9(b), is inconsistent with the pleading standard established in *Bell Atlantic Corp. v. Twombly*, 127 S. Ct. 1955 (2007), and the teachings of *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007), and improperly precludes application of the "Sounds in Fraud Doctrine" to stand-alone claims under the Securities Act of 1933.

## PARTIES TO THE PROCEEDING

The parties to this proceeding, identified below, constitute all the parties to the proceedings in both the district court and the court of appeals.

**Petitioners**

The following parties are Petitioners herein. Each was a defendant in the district court and an appellee in the court of appeals. By function, the Petitioners are:

1. *Corporate Defendant:* Merix Corporation.
2. *Merix's Officers (sometimes referred to herein as the "Individual Defendants"):* Mark Hollinger, Janie S. Brown, Anaya K. Vardya and Daniel T. Olson.
3. *Merix's Directors:* Kirby Dyess, Carlene Ellis, Donald Jobe, George Keckhove, William Lattin, William McCormick and Robert Strandberg.
4. *Underwriters for Merix's Secondary Offering:* UBS Securities LLC, Thomas Weisel Partners LLC, Needham & Company, Inc., Wells Fargo Securities, LLC, Raymond James & Associates, Inc., and William Blair & Company, LLC.

**Respondent**

Central Laborers Pension Fund is the Respondent herein. It was appointed as the lead plaintiff in the district court and was the appellant in the court of appeals.

## CORPORATE DISCLOSURE STATEMENTS

Pursuant to Supreme Court Rule 29.6, the corporate Petitioners, each on its own behalf, disclose that:

1. Merix Corporation has no parent corporation and no publicly held company owns 10% or more of its stock.

2. UBS Securities LLC is owned by UBS AG, a publicly held corporation, and UBS AG's wholly-owned subsidiary, UBS Americas Inc. No other publicly held company owns 10% or more of its stock.

3. Wells Fargo Securities, LLC is a subsidiary of Wells Fargo & Company, a publicly held corporation. No other publicly held company owns 10% or more of its stock.

4. Needham & Company, Inc. is a subsidiary of The Needham Group. No publicly held company owns 10% or more of its stock.

5. Thomas Weisel Partners LLC is a subsidiary of Thomas Weisel Partners Group, Inc., a publicly held corporation. No other publicly held company owns 10% or more of its stock.

6. Raymond James & Associates, Inc. is a subsidiary of Raymond James Financial, Inc., a publicly held corporation. No other publicly held company owns 10% or more of its stock.

7. William Blair & Company, LLC has no parent corporation and no publicly held company owns 10% or more of its stock.

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Merix Corporation, Mark Hollinger, Janie S. Brown, Anaya K. Vardya, Daniel T. Olson, Kirby Dyess, Carlene Ellis, Donald Jobe, George Keckhove, William Lattin, William McCormick, Robert Strandberg, UBS Securities LLC, Thomas Weisel Partners LLC, Needham & Company, Inc., Wells Fargo Securities, LLC, Raymond James & Associates, Inc., and William Blair & Company, LLC, respectfully request that a writ of certiorari issue to review the judgment entered in this case by the United States Court of Appeals for the Ninth Circuit.

## OPINIONS BELOW

The memorandum decision of the court of appeals (App. 1a-3a) is unreported. The district court's opinion (App. 4a-6a) that dismissed the Second Amended Consolidated Complaint ("SAC") and was the subject of the court of appeals' decision is unreported. The district court's earlier opinion (App. 7a-43a) that dismissed the First Amended Consolidated Complaint ("FAC"), but was not a subject of the court of appeals' decision, is unreported.

## JURISDICTION

The court of appeals entered judgment on April 22, 2008. It denied a timely petition for rehearing on June 24, 2008. (App. 44a-45a.) The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

## CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

This petition concerns Federal Rule of Civil Procedure 9(b) and claims under Sections 11, 12 and 15 of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. §§ 77k, 77l and 77o. Rule 9(b) is reproduced in the Appendix at page 57a. The Securities Act provisions are reproduced in the Appendix at pages 46a-56a. No constitutional provisions are involved.

## STATEMENT OF THE CASE

This case raises important, recurring questions concerning (1) whether a district court, in deciding a motion to dismiss an amended complaint, must give effect to factual allegations in the amended pleading that contradict factual allegations in an earlier version of that pleading, and (2) the standard for determining whether claims under the Securities Act sound in fraud and therefore are subject to Rule 9(b).

Most courts to have considered the issue require plaintiffs to plead with particularity Securities Act claims that sound in fraud. Here, however, the Ninth Circuit permitted plaintiff to evade the "Sounds in Fraud Doctrine" through two rulings that conflict with decisions of other federal courts of appeals. First, the Ninth Circuit permitted plaintiff to plead in the SAC factual allegations that contradicted fraud-based factual allegations made in the FAC. Second, using a standard more restrictive than that used by other

federal appellate courts, the Ninth Circuit ruled that the SAC did not sound in fraud because plaintiff specifically alleged neither fraud nor acts that "*necessarily* constitute fraud." (App. 2a (citing *Vess v. Ciba-Geigy Corp. USA*, 317 F.3d 1097, 1104-05 (9th Cir. 2003) (emphasis in original).)[1] The latter ruling is also inconsistent with decisions of this Court.

**A. Plaintiff's Claims**

As pleaded in the SAC, this case concerns plaintiff's contention that the Prospectus for Merix's January 2004 secondary public offering (the "Offering") contained over three dozen material misstatements and omissions, violating Sections 11, 12(a)(2) and 15 of the Securities Act.

**B. Merix's Operations**

Merix manufactures printed circuit boards ("PCBs") for use in sophisticated electronic equipment. (ER39 [¶45].)[2] All production occurred in Forest Grove, Oregon, until early 2004, when Merix opened a new plant in Wood Village, Oregon, as part of a multi-year facilities expansion. (SER118, SER124, SER149.)

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[1] The same Ninth Circuit panel reached a similar conclusion on this issue in *Safron Capital Corp. v. Leadis Technology, Inc.*, 2008 WL 1776407 (9th Cir. Apr. 18, 2008) (unreported), *rev'g In re Leadis Technology, Inc. Sec. Litig.*, 2006 WL 496039 (N.D. Cal. Mar. 1, 2006) (unreported).

[2] "ER" refers to plaintiff's Excerpts of Record filed in the Ninth Circuit. "SER" refers to defendants' Supplemental Excerpts of Record.

Historically, most of Merix's sales were to "a limited number of customers." (SER123.) The Prospectus stated that, for fiscal years 2001 through 2003, Merix's "top five OEM customers, which vary from year to year," represented between 60% and 65% of net sales. (SER144.) In each of those years, Cisco Systems, Inc. and Motorola, Inc. both accounted for more than 10% of Merix's net sales. (SER144.)

### C. Merix's Revised Sales Projections

On May 3, 2004, more than three months after the Offering, Merix pre-announced a downward revision of projected sales for the then-current quarter. (ER32 [¶12], ER64 [¶115].) Merix attributed the revision to reduced overall demand for its higher-priced products, in addition to "reduced orders from a major customer, which the Company understood resulted from decreased demand for certain of the customer's products and increased inventory levels in their supply chain." (ER64 [¶115].) Merix also "expect[ed] a further reduction in sales and a scrap loss resulting from a manufacturing process error." (ER64 [¶115].) On June 30, 2004, Merix announced, based on its ongoing assessment of market conditions, "that it was putting the brakes on the . . . Wood Village expansion in response to current lower demand levels." (ER65 [¶118].)

Although the Prospectus warned of the very risks that befell Merix — i.e., risks of a decline in demand for Merix's products (SER122-24), of potential product defects (SER125), of integration

issues related to the facilities expansion plan (SER118, SER124-25), and of stock price volatility (SER128-29), among others — class action lawsuits predictably followed once these risks materialized.

## D. Course of Proceedings and Disposition

### 1. First Amended Consolidated Complaint

Plaintiff filed the FAC on November 15, 2004, asserting claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 ("Exchange Act") and Sections 11, 12(a)(2) and 15 of the Securities Act. The district court had subject-matter jurisdiction pursuant to Section 27 of the Exchange Act, 15 U.S.C. § 78aa; Section 22 of the Securities Act, 15 U.S.C. § 77v; and 28 U.S.C. § 1331.

According to the FAC, Merix with the other defendants' assistance "pocketed" more than $83 million in proceeds from the Offering by intentionally conditioning the market through a series of misrepresentations and omissions — including in the Prospectus — concerning Merix's customer base, demand for its products, benefits of the planned facilities expansion, and its financial accounting and reporting, while certain defendants took advantage of an elevated stock price by "engag[ing] in more than $3 million in illegal insider sales." (SER5-7 [¶¶3-7].)

In an Opinion and Order dated September 15, 2005, the district court dismissed the FAC with leave to amend, holding that

(1) plaintiff had not pled its Exchange Act claims with the particularity required by the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) ("Reform Act") (codified in pertinent part at 15 U.S.C. § 78u-4(b)(1)-(2)) and (2) its Securities Act claims "sound[ed] in fraud" but lacked the particularity required by Rule 9(b). (App. 14a-21a, 27a-41a.)[3] With respect to the Securities Act claims, the court stated:

> The substance of the alleged misrepresentations and omissions that form the basis of Plaintiff's Securities Act claims is virtually identical to that of the statements underlying its Exchange Act claims — namely, exaggerated customer demand, overstated earnings, and overly optimistic statements about the Wood Village facility. Plaintiff does not explain how misstatements knowingly made before and after the issuance of the Prospectus could have been merely negligently made in relation to the

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[3] The district court also dismissed plaintiff's Section 12(a)(2) claims (1) with prejudice against the Underwriter Defendants, to the extent asserted on behalf of persons who did not purchase securities directly from them pursuant to the Prospectus (App. 41a-42a); and (2) without prejudice against Merix, Hollinger and Brown because they were not "sellers" (App. 21a-26a). Plaintiff did not replead these claims in the SAC and did not appeal their dismissal.

> Prospectus — particularly when the complaint alleges that the Prospectus incorporated by reference Merix's previously announced financial information.

(App. 20a-21a.)

**2. Second Amended Consolidated Complaint**

Plaintiff filed the SAC on November 18, 2005. Reflecting its inability to plead with particularity, plaintiff dropped its Exchange Act claims and purported to assert only "non-fraud" Securities Act claims. (ER33 [¶14].) Without differentiating among the defendants or their conduct or knowledge, plaintiff alleged summarily that all defendants acted negligently by failing to "make a reasonable and diligent investigation of the statements contained in the January Prospectus." (ER37-38 [¶42].)

Despite its obvious efforts to evade Rule 9(b), plaintiff repeated the FAC's core allegations concerning misstatements and omissions about Merix's customer base (including one of its largest customers), demand for its products, its facilities expansion plan, its quality assurance program, and its financial statements. (ER30-33 [¶¶6-13].) Plaintiff also alleged that the Prospectus's risk disclosures "were materially false, misleading and/or incomplete as the January Prospectus did not disclose that the described risks had already

come to pass and were adversely affecting Merix's business." (ER52-53 [¶¶82-83].)

On January 26, 2006, defendants moved to dismiss the SAC, contending that (1) despite artful efforts to evade Rule 9(b), the SAC sounded in fraud and, given that plaintiff had done nothing to particularize its pleading, failed to satisfy Rule 9(b); and (2) even if Rule 9(b) did not apply, dismissal with prejudice was required because, taken as true, plaintiff's allegations did not render the Prospectus false or misleading.

At oral argument, the district court questioned counsel about how to determine whether the SAC sounds in fraud and plaintiff's theory that negligence underlies its claims. (ER139-46, ER149-66.) Unpersuaded by plaintiff's arguments, the court dismissed the SAC with prejudice on September 28, 2006, explaining that after it "stripped plaintiff's §§ 11 and 12(a)(2) claims of all allegations of fraud insufficiently plead under Rule 9(b)," only a "few paragraphs" remained that "could plausibly allege negligent conduct." (App. 5a.) These "few paragraphs," the court held, were "insufficient to state a claim of negligence." (App. 5a.) Judgment was entered on September 29, 2006. (ER257.)

### 3. The Appeal

The Ninth Circuit reversed on two grounds. First, the panel majority held that plaintiff was not foreclosed from making allegations in the SAC that were inconsistent with or contradicted allegations

in the FAC. (App. 2a.) Second, it held that the Sounds in Fraud Doctrine did not apply because fraud is not an essential element of a Securities Act claim and the SAC specifically alleged neither fraud nor facts that "necessarily constitute fraud." (App. 2a.)

In a concurrence, Judge Rymer questioned whether the "necessarily constitute fraud" standard conflicts with court precedents involving Securities Act claims. (App. 3a.) In addition, Judge Rymer found it

> tough to read the amended pleading in this case as claiming anything other than a classic securities fraud. For sure, the magic words are missing, and the plaintiff is the master of the complaint; still, the scheme alleged in the amended pleading walks and talks like fraud, as did the scheme averred in the original pleading. It's hard to say that Merix's reputational harm (which Rule 9(b) is there to protect) is any less obvious in the amended pleading than it was in the original pleading. . . .

(App. 3a.)

On May 13, 2008, defendants filed a joint petition for rehearing with a suggestion for rehearing en banc. The court denied that petition on June 24, 2008, with Judge Rymer dissenting. (App. 44a-45a.)

## REASONS FOR GRANTING THE PETITION

The decision of the court of appeals creates circuit conflicts on important issues of federal law: (1) whether, in evaluating an amended complaint, a district court must give effect to factual allegations in that pleading even when they conflict with factual allegations in a pre-amended version of the complaint; and (2) the standard to be used to determine whether Securities Act claims sound in fraud. On the second issue, the court of appeals' decision also is inconsistent with pleading standards announced by this Court.

The Ninth Circuit is the first federal appeals court to rule that a district court may not consider allegations in a prior complaint that conflict with factual allegations in an amended complaint. Under the Ninth Circuit's ruling, plaintiffs, without justification or explanation — and even following dismissal of a complaint — may disregard facts they previously alleged and, in a subsequent complaint, plead different and even conflicting or contradictory facts solely to comply with pleading requirements of their claims. Encouraging such tactical adaptive pleading to preserve claims is inefficient and needlessly prolongs litigation. By contrast, other federal appeals courts — and even the Ninth Circuit, until recently — recognize that a district court evaluating an amended complaint properly may reject factual allegations that contradict those in an earlier version of the complaint.

Although this issue arises here in the context of Securities Act claims and the Sounds in Fraud Doctrine, its import is broader. Its determination will affect every case in which factual allegations in an amended complaint conflict with factual allegations in an earlier version of that complaint, and potentially will place an essential limitation on the general principle that an amended complaint supersedes its predecessors.

The Ninth Circuit is also the first federal appeals court to use the "necessarily constitute fraud" standard to determine whether Securities Act claims sound in fraud. Other appeals courts that recognize the applicability of the Sounds in Fraud Doctrine to Securities Act claims — and, prior to this case and *Leadis*, the Ninth Circuit too — focus on whether fraud constitutes the essence or "gravamen" of the plaintiff's claim or, in the words of one Circuit, whether the language of the complaint is "classically associated with fraud."

By its terms, the "necessarily constitute fraud" standard imposes on those who invoke the Sounds in Fraud Doctrine the burden to establish beyond a doubt, at the pleading stage, that alleged misrepresentations and material omissions in a prospectus could result only from fraud. This burden is not only greater than the burden imposed by the "gravamen" standard, but is inconsistent with the threshold pleading standard and approaches adopted by this Court in *Bell Atlantic Corp. v. Twombly*, 127 S. Ct. 1955 (2007), and

*Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007), respectively.

Indeed, the "necessarily constitute fraud" standard effectively makes the Sounds in Fraud Doctrine inapplicable to Securities Act claims unless they are part of a complaint that includes fraud claims under the Exchange Act. In appropriate cases, however, courts (including the district court below, *see* App. 4a-6a) have applied the Sounds in Fraud Doctrine to Securities Act claims where the complaint does not contain Exchange Act claims. *See, e.g., Leadis*, 2006 WL 496039, *3-5; *Rhodes v. Omega Research, Inc.*, 38 F. Supp. 2d 1353, 1359-61 (S.D. Fla. 1999); *In re Anchor Gaming Sec. Litig.*, 33 F. Supp. 2d 889, 892-93 (D. Nev. 1999); *Schoenhaut v. American Sensors, Inc.*, 986 F. Supp. 785, 795-96 (S.D.N.Y. 1997); *Competitive Associates, Inc. v. Fire Fly Enterprise, Inc.*, 59 F.R.D. 336, 338 (S.D.N.Y. 1972). Furthermore, despite opportunity to do so, Congress has not seen fit to abolish application of this doctrine to stand-alone Securities Act claims.

Petitioners request the Court to grant their petition to resolve these conflicts and to establish national uniformity on these recurring and important matters.

## I. IN HOLDING THAT DISTRICT COURTS MUST GIVE EFFECT TO ALLEGATIONS IN AN AMENDED COMPLAINT THAT CONFLICT WITH OR CONTRADICT ALLEGATIONS IN A PRIOR VERSION OF THAT PLEADING, THE NINTH CIRCUIT'S DECISION CONFLICTS WITH RULINGS OF OTHER FEDERAL APPEALS COURTS

### A. The Ninth Circuit's Decision Conflicts With Federal Appellate Decisions Recognizing That District Courts May Decline to Give Effect to Factual Allegations in an Amended Complaint That Conflict With Those in an Earlier Version of That Pleading

Prior to *PAE Government Services, Inc. v. MPRI, Inc.*, 514 F.3d 856 (9th Cir. 2007), it was generally settled that a district court need not accept as true factual allegations in an amended complaint that conflict with facts alleged in an earlier complaint. As Judges Schwarzer and Tashima observe in their treatise:

> The District Court is not required to accept as true allegations in an amended complaint that, without any explanation, contradict an earlier complaint. The court may strike the changed allegations as "false and sham" and dismiss the complaint for failure to state a claim.

WILLIAM W. SCHWARZER, ET AL., FEDERAL CIVIL PROCEDURE BEFORE TRIAL ¶9:223.5 (nat'l ed. 2008) (citations omitted). The Ninth Circuit squarely rejected this proposition in *PAE*, holding that a district court has no authority to strike or disregard allegations in an amended complaint simply because they conflict with allegations in an earlier version of the complaint. 514 F.3d at 859.[4] The Ninth Circuit in the instant case followed *PAE* in ruling that plaintiff "is not foreclosed from making allegations or claims in the SAC that are inconsistent with or contradicted by allegations or claims made in [its] previous complaint." (App. 2a.)

The Ninth Circuit's holdings in *PAE* and the instant case directly conflict with the Federal Circuit's decision in *Bradley v. Chiron Corp.*, 136 F.3d 1317 (Fed. Cir. 1998), and even with earlier decisions of the Ninth Circuit itself.[5]

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[4] Although the Ninth Circuit noted in *PAE* that the court may strike pleadings or allegations under the procedures set forth in Federal Rule of Civil Procedure 11, 514 F.3d at 859, such authority was not at issue in that case and is not implicated here.

[5] In *Reddy v. Litton Industries, Inc.*, 912 F.2d 291 (9th Cir. 1990), *cert. denied*, 502 U.S. 921 (1991), the Ninth Circuit affirmed the dismissal of a complaint without leave to amend because: "It would not be possible for Reddy to amend his complaint to allege a completely new injury that would confer standing to sue without contradicting any of the allegations of his original complaint. Although leave to amend should be liberally granted, the amended complaint may only allege 'other facts consistent with the challenged pleading.'" *Id.* at

In *Bradley*, the district court dismissed the plaintiff's second amended complaint, reasoning that "[i]f a party will not be granted leave to amend to allege facts inconsistent with the dismissed pleading, it follows that, after granting leave to amend, the court is not required to accept such inconsistent allegations as true." *Bradley v. Chiron Corp.*, 1996 WL 441022, *3 (N.D. Cal. July 15, 1996) (unreported) (citing *Reddy*, 912 F.2d at 296-97). The court observed that the 104-page original complaint, filed a year before the second amended complaint, represented a fresher recollection and "clearly constituted a comprehensive statement of the plaintiff's allegations and claims." *Id.* at *5. But the plaintiff "so diametrically reversed his recollection and position between the time of the filing of his original complaint and that of his second amended pleading," without any credible explanation, that the court concluded that the amended pleading did not reflect good faith and was merely an effort to respond to the ruling that dismissed his prior complaint. *Id.*

The Federal Circuit agreed "that the new pleadings exceeded permissible adjustment of

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296-97. Despite this clear holding, the panel in *PAE* dismissed *Reddy* as standing only for the "unremarkable proposition that, where a complaint cannot be cured by amendment, the district court may deny leave to amend under Rule 15." 514 F.3d at 859 & n.4. *PAE* thus violates the principle that, absent relevant intervening Supreme Court precedent, one appellate panel may not overrule decisions of another panel. *See Truth v. Kent School District*, ___ F.3d ___, 2008 WL 4138232, *8-9 (9th Cir. 2008).

factual allegations" and that the changes had not been adequately explained. *Bradley*, 136 F.3d at 1325. The court rejected the plaintiff's argument that the liberal pleading policy of the Federal Rules and the principle that an amended complaint supersedes prior pleadings made irrelevant the inconsistency between the complaints, emphasizing that the second amended complaint was filed by leave of court, not as of right. *Id.* Under this circumstance, and relying in part on *Reddy*, the court held that the district court was not required to accept as true the inconsistent allegations in the second amended complaint and did not abuse its discretion in striking that complaint's "changed and inconsistent factual allegations" on grounds that they were "false and sham." *Id.* at 1325-26.

This approach has been suggested by other Circuits as well. *See, e.g., Belizan v. Hershon*, 434 F.3d 579, 584 (D.C. Cir. 2006) (remanding to district court to "determine whether the allegation of other facts consistent with the challenged pleading could not possibly meet the heightened pleading requirements of the PSLRA"); *Asher v. Harrington*, 461 F.2d 890, 895 (7th Cir. 1972) (test for determining whether to grant leave to amend when dismissing a complaint "is whether or not the allegation of other facts consistent with the challenged pleading could cure the deficiency in the complaint"); *accord Wallace v. New York City Department of Corrections*, 1996 WL 586797, *2 (E.D.N.Y. Oct. 9, 1996) (unreported) ("The plaintiff blatantly changes his statement of the facts in order to respond to the defendants' motion to

dismiss. In this amended complaint, the plaintiff directly contradicts the facts set forth in his original complaint. The court accepts the facts as described in the original complaint as true . . . ."); *cf. Karnes v. Poplar Bluff Transfer Co. (In re Atlas Van Lines, Inc.)*, 209 F.3d 1064, 1067 (8th Cir. 2000) ("when a district court orders a party to amend its complaint or when the decision to amend is otherwise involuntary, the question of proper removal must be answered by examining the original rather than the amended complaint").

Given the conflict between the Ninth Circuit's current position and the position taken by other federal courts of appeals, this Court should grant certiorari and clarify for future litigants that, although an amended complaint may supersede earlier complaints for some purposes, courts need not give effect to factual allegations of an amended complaint that conflict with the allegations of an earlier complaint.

### B. The Ninth Circuit's Decision Conflicts With Federal Appellate Decisions That Preclude Tactical Amendments

As in *Bradley*, plaintiff did not explain or justify the material contradiction between the SAC and the FAC's fraud allegations. Plaintiff did not even explain how or when it learned of the allegedly negligent investigation. Because no discovery has occurred, *see* 15 U.S.C. §§ 77z-1(b)(1), 78u-4(b)(3)(B), it is logical to conclude that (1) plaintiff knew whatever it does about an allegedly negligent investigation before it filed the

FAC, but declined to include such allegations in the FAC so as not to undermine its effort to plead fraud under the Exchange Act, and (2) the SAC's inclusion of a boilerplate allegation of negligent investigation reflects "a transparent attempt to conform the facts to the requirements of the cause of action" — precisely what *Bradley* precludes. *See Bradley*, 136 F.3d at 1324; *see also Frank v. U.S. West, Inc.*, 3 F.3d 1357, 1366 (10th Cir. 1993) (where a party seeking to amend "'knows or should have known of the facts upon which the proposed amendment is based but fails to include them in the original complaint, the motion to amend is subject to denial'").

As the Former Fifth Circuit has stated, such an

> awareness of facts and failure to include them in the complaint might give rise to the inference that the plaintiff was engaging in tactical maneuvers to force the court to consider various theories seriatim. In such a case, where the movant first presents a theory difficult to establish but favorable and, only after that fails, a less favorable theory, denial of leave to amend on the grounds of bad faith may be appropriate.

*Dussouy v. Gulf Coast Investment Corp.*, 660 F.2d 594, 599 (Former 5th Cir. Nov. 1981); *accord Industrial Assets, Inc. v. Capital Equipment Sales Co.*, 1997 WL 359061, *4 (6th Cir. June 26, 1997)

(unreported) (holding that district court did not abuse its discretion in denying leave to amend where plaintiff asserted a "spurious" claim on one basis and then, following dismissal of the first complaint, sought to assert claims seeking recovery on a different basis); *Kraus v. State Farm Mutual Automobile Ins. Co.*, 2004 WL 2830889, *7 (Del. Super. Ct. Apr. 23, 2004) (unreported) ("Allowing Plaintiffs to amend their complaint to aver contradictory facts, as opposed to averring a newly discovered fact or an alternative theory of the case, would be an attempt to 'manipulate the course of litigation' [and would] undercut the finality of [previously decided motions to dismiss and motions for summary judgment]." (footnote and citations omitted; alterations added)). That is precisely the situation here: only after plaintiff failed successfully to plead claims under the Exchange Act (which would have provided a more expansive class period) did it (without benefit of discovery) allege an inadequate investigation.

### C. Numerous Facts Alleged in the FAC Conflict With Plaintiff's Allegation in the SAC That Its Securities Act Claims Are Grounded in Negligence

In stark contrast to the SAC's allegation of negligence,[6] in the FAC plaintiff attributed the

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[6] Other than a conclusory disclaimer of fraud (ER33 [¶14]), the sole allegation in the SAC supporting plaintiff's contention that its claims are predicated on negligence rather than fraud is that "none of the defendants named in this Count made a reasonable investigation or possessed

allegedly false statements in the Prospectus to defendants' intentional effort to "condition[ ] the market" through a series of misrepresentations and omissions so that Merix could "pocket[ ] more than $83 million from unsuspecting investors" while certain defendants sold personal holdings of Merix stock at inflated prices. (SER5-6 [¶¶3-4, 6], SER24-44 [¶¶54-79], SER90-108 [¶¶191-230, 234].) As in *Bradley*, plaintiffs newly minted negligence allegation, made without explanation in response to dismissal of the FAC, conflicts with its prior allegations of intentional conduct.

The conflict is even more striking when considering specific alleged misstatements. For example, plaintiffs contention that defendants negligently failed to investigate and/or lacked a reasonable basis to believe statements in the Prospectus related to customer demand and orders directly conflicts with allegations in the FAC that defendants knew about the status of customer demand and orders. Among other things, the FAC alleged:

- "Merix management, including the Individual Defendants, were intimately involved in all aspects of Merix's business." (SER96 [¶203].)

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reasonable grounds for believing that the statements contained in the January Prospectus were true and devoid of any misstatements or omissions of material fact." (ER70 [¶131]; *accord* ER37-38 [¶42], ER73 [¶145].)

- "[D]efendants had real-time access to the status of Merix's declining sales through the 'Computer On-Line Loading and Tracking' [COLT] system," which was updated "at least every **two hours**" and contained "information about the number of boards in an order." (SER99-100 ¶¶214-216].)

- "[D]efendants knew how Merix was performing on a daily basis" because "ship dates were requested by and agreed upon by the customers." (SER100-01 [¶217].)

- Defendant Olson participated in weekly conference calls "to discuss sales results." (SER96 [¶204].)

- "[A]s a result of the constant pressure to meet sales goals, the managers in Forest Grove met with defendants Hollinger, Vardya and Brown **weekly** to discuss the previous week's sales numbers and shipments, as compared to the target for the plant." (SER96 [¶205].)

Similarly, the SAC's allegations of an inadequate investigation or lack of a reasonable basis to believe statements in the Prospectus concerning product quality contradict the FAC's allegations that the defendants knew of product quality problems. For example, the FAC stated:

- In accord with defendant Vardya's directions, quality assurance auditors were instructed merely to "glance" at product on which manufacturing problems had been identified, "so that it could be shipped to customers." (SER53 [¶101], SER97-98 [¶207].)
- "[D]efendants instructed employees to further 'rush' quality assurance on quick-turn orders to expedite shipment, leading to further mistakes." (SER53 [¶102].)
- "[O]n more than one occasion during the Class Period, Motorola returned entire orders because every board had a defect. . . . [T]hese issues with Motorola products strained Merix's relationship with Motorola." (SER54 [¶103].)
- "[A] specific PCB created for Motorola was of such poor quality that it was returned for quality issues 90% of the time during W-7's tenure with the Company." (SER58 [¶114].)
- "[D]efendants had real-time access to . . . the 'Computer On-Line Loading and Tracking' [COLT] system," which was updated "at least every **two hours**" and contained "information about each test, such as whether the order passed or failed [and] details of

any defects or damages." (SER99-100 [¶¶214-216].)

Although plaintiff attempted during oral argument in the district court to buttress its negligence theory, it did not expound on the SAC's negligent investigation allegation. Instead, plaintiff speculated that certain information might not have reached upper management or that upper management mistakenly might have concluded that information was immaterial and did not require disclosure. (ER149-50, ER156.) The district court properly did not credit these unpled, speculative contentions, unsupported by facts alleged in the SAC. *See, e.g., Manufactured Home Communities, Inc. v. City of San Jose*, 420 F.3d 1022, 1035 (9th Cir. 2005); *Moses.com Securities, Inc. v. Comprehensive Software Systems, Inc.*, 406 F.3d 1052, 1064.(8th Cir. 2005).

Plaintiff did not even try to propose a negligence theory for its allegations of improper revenue recognition and inflated financial statements. Nor could it credibly do so given its prior factual allegations plainly asserting that this conduct was intentional. For example, plaintiff alleged in the FAC that defendants Brown, Hollinger and Vardya drove "the improper deferral of expenses to artificially inflate Merix's revenues" and that this "'game playing' was a consistent practice at Merix" because meeting financial projections "drove up the stock price." (SER62-63 [¶¶127, 129], SER97 [¶206].) *Cf. In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d 1248, 1273

(N.D. Cal. 2000) ("books do not cook themselves"). Plaintiff also alleged that public statements before and after the Prospectus (including Merix financial statements incorporated by reference into the Prospectus) — all of which had been subjects of plaintiff's dismissed Exchange Act claims — contained the same allegedly false information that plaintiff identifies in the Prospectus. (*Compare* SER24-31 [¶¶54-58, 60] and SER38-44 [¶¶74-79] *with* SER32-38 [¶¶64-73] and ER43-45 [¶¶60-90].) *See In re IAC/InterActiveCorp Sec. Litig.*, 478 F. Supp. 2d 574, 595-96 (S.D.N.Y. 2007) (holding that claim "plainly sounds in fraud" where registration statement incorporated by reference Form 10-K that plaintiff alleged as a basis for liability under the Exchange Act).[7]

If the Ninth Circuit had followed *Bradley* and *Dussouy*, and refused to give effect to the allegations of negligence in the SAC that conflicted with allegations of knowing conduct in the FAC, it would have been hard-pressed to conclude that the SAC does not sound in fraud.

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[7] Nor did plaintiff discuss either at oral argument in the district court or in its appellate briefs how negligence might underlie its allegations concerning when production at Wood Village began and whether the Prospectus's risk disclosures were themselves false and misleading. It therefore waived such arguments. *Dennis v. BEH-1, LLC*, 520 F.3d 1066, 1069 n.1 (9th Cir. 2008).

## II. THE "NECESSARILY CONSTITUTE FRAUD" STANDARD CONFLICTS WITH DECISIONS OF THIS COURT AND OTHER FEDERAL APPEALS COURTS, AND RAISES SUBSTANTIAL QUESTIONS ABOUT THE VIABILITY AND SCOPE OF THE SOUNDS IN FRAUD DOCTRINE

The Sounds in Fraud Doctrine makes all allegations in a complaint that are premised on fraudulent conduct subject to the pleading requirements of Rule 9(b), even when fraud is not a necessary element of the claim with respect to which the fraud allegations are made. Federal appeals courts that have considered the issue have held almost uniformly that the Sounds in Fraud Doctrine applies to claims under the Securities Act. *See, e.g., ACA Financial Guaranty Corp. v. Advest, Inc.*, 512 F.3d 46, 68 (1st Cir. 2008); *Rombach v. Chang*, 355 F.3d 164, 171 (2d Cir. 2004); *California Public Employees' Retirement System v. Chubb Corp.*, 394 F.3d 126, 160-63 (3d Cir. 2004) [hereinafter *CALPERS*]; *Lone Star Ladies Investment Club v. Schlotzsky's, Inc.*, 238 F.3d 363, 368 (5th Cir. 2001); *Sears v. Likens*, 912 F.2d 889, 892-93 (7th Cir. 1990); *Sparling v. Daou (In re Daou Systems, Inc., Sec. Litig.)*, 411 F.3d 1006, 1027-28 (9th Cir. 2005), *cert. denied*, 546 U.S. 1172 (2006); *Wagner v. First Horizon Pharmaceutical Corp.*, 464 F.3d 1273, 1278 (11th Cir. 2006). Only the Eighth Circuit has declined to apply the Sounds in Fraud Doctrine to any Securities Act claims, *see Carlon v. Thaman (In re NationsMart Corp. Sec.*

*Litig.)*, 130 F.3d 309, 314 (8th Cir. 1997) [hereinafter *NationsMart*], *cert. denied*, 524 U.S. 927 (1998), although in dictum the Eleventh Circuit suggested that it would apply the Sounds in Fraud Doctrine to Securities Act claims only if the complaint also contains fraud-based Exchange Act claims, *see Wagner*, 464 F.3d at 1278.

In this case, the Ninth Circuit employed a standard which suggests that the Sounds in Fraud Doctrine has vitality with respect to all Securities Act claims, but in practice makes it virtually — if not actually — impossible for that doctrine to apply to stand-alone Securities Act claims. It ruled that, absent a unified course of fraudulent conduct — i.e., where the complaint contains both fraud and nonfraud claims and the plaintiff pleads the same facts to support both — the Sounds in Fraud Doctrine applies to Securities Act claims only if the plaintiff specifically alleges either fraud or facts that "necessarily constitute fraud." (App. 2a (citing *Vess*, 317 F.3d at 1104-05)).

As Judge Rymer noted in her concurrence, *Vess*, on which the majority relied, did not arise under the federal securities laws, which caused her to question *Vess*'s applicability to plaintiff's claims. (App. 3a.) Indeed, as explained below, the approach taken by the panel majority should not be applied to Securities Act claims because it is inconsistent with pleading standards established by this Court, conflicts with standards used by other federal appellate courts when applying the Sounds in Fraud Doctrine to Securities Act claims,

and conflicts with congressional intent and important principles of public policy.

### A. Rule 9(b) Requires Application of the Sounds in Fraud Doctrine to All Securities Act Claims Premised on Fraud

Both the Eighth and Eleventh Circuits decline to apply the Sounds in Fraud Doctrine to stand-alone Securities Act claims. This is wrong because their respective approaches conflict with the plain language of Rule 9(b). By its terms, Rule 9(b) applies to all allegations of fraud. Fed. R. Civ. P. 9(b). It "is cast in terms of the conduct alleged, and is not limited to allegations styled or denominated as fraud or expressed in terms of the constituent elements of a fraud cause of action." *Rombach*, 355 F.3d at 171.[8]

Given the plain language of Rule 9(b) and its purpose to protect defendants from harm to their goodwill and reputation, *see, e.g.*, *United States ex rel. Harrison v. Westinghouse Savannah River Co.*, 352 F.3d 908, 921 (4th Cir. 2003); *Rombach*, 355 F.3d at 171, no principled basis exists to employ different standards, depending on whether or not a Securities Act claim is joined to Exchange Act claims. If the claim is premised on fraud, the Sounds in Fraud Doctrine should apply,

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[8] Prior to December 2007, Rule 9(b) referenced "averments of fraud." The change from "averments of fraud" to "alleging fraud" is not substantive, but only stylistic. *See* Fed. R. Civ. P. 9 advisory committee's note (2007).

the principal issue then being the standard to be used in applying it.

### B. The "Necessarily Constitute Fraud" Standard Is Inconsistent With Pleading Standards Established by This Court

The "necessarily constitute fraud" standard is inconsistent with the general pleading standard established by this Court in *Twombly*, 127 S. Ct. 1955, and the teaching of *Tellabs*, 127 S. Ct. 2499, with respect to pleading requirements for securities-related fraud claims. The Ninth Circuit did not address either *Twombly* or *Tellabs*.

In *Twombly*, the Court "retire[d]" the notion that a complaint should survive a Rule 12(b)(6) motion "'unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief.'" 127 S. Ct. at 1968 (quoting *Conley v. Gibson*, 335 U.S. 41, 45-46 (1957)). Instead, the Court directed that, to avoid dismissal, a complaint must present a claim that is plausible and not merely "conceivable" or "consistent with" wrongful conduct. *Id.* at 1965-66, 1974. In short, *Twombly* made plausibility the "touchstone for adequate pleading." *In re Take-Two Interactive Sec. Litig.*, 551 F. Supp. 2d 247, 259 (S.D.N.Y. 2008).

The "necessarily constitute fraud" standard ignores *Twombly*'s emphasis on plausibility. Rather than asking whether it is plausible that fraud underlies a claim, this standard improperly forces defendants to show that fraud is the only

possible explanation for a claim or allegation — i.e., the "necessar[y]" explanation — before the Sounds in Fraud Doctrine can apply. Thus, as long as a negligence explanation is conceivable, though unlikely, this standard precludes courts from finding that allegations concerning false statements sound in fraud even when, based on the plaintiff's own fact allegations, fraud is the *most* plausible explanation for why those statements were made. It effectively forces defendants to show beyond doubt that fraud alone can explain allegedly false statements for the Sounds in Fraud Doctrine to apply. But *Twombly* rejected "beyond doubt" burdens at the pleading stage. 127 S. Ct. at 1968-69.

In harmony with *Twombly*'s focus on plausibility, *Tellabs* instructs district courts ruling on motions to dismiss to assess the plausibility of competing inferences that may be drawn from the allegations of a complaint. 127 S. Ct. at 2510.[9] In a *Tellabs*-style analysis, for example, a plaintiff's contention that its claim does not rely on fraud or is premised on negligence would be considered along with other plausible inferences, including fraud. Contrary to the position of the Third and Fifth Circuits, *see Teachers Retirement System v. Special*

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[9] The Court in *Tellabs* held that to plead a strong inference of scienter under the Exchange Act, facts alleged in the complaint must create an inference of fraudulent intent that is at least as compelling as any competing inference (although it need not be the "most plausible of competing inferences"). 127 S. Ct. at 2510.

*Situations Fund, III, L.P. (In re Suprema Specialties, Inc. Sec. Litig.)*, 438 F.3d 256, 272-73 (3d Cir. 2006) [hereinafter *Suprema*]; *Schlotzsky's*, 238 F.3d at 369, a disclaimer of fraud would not be determinative.[10] Moreover, consistent with *Twombly*'s direction that to survive a motion to dismiss a complaint must contain sufficient factual allegations "to raise a right to relief above the speculative level," 127 S. Ct. at 1965, boilerplate assertions that claims are based on negligence, or a purported failure adequately to investigate, would be insufficient. *See, e.g., Kendall v. VISA, U.S.A., Inc.*, 518 F.3d 1042, 1050 (9th Cir. 2008) (citing *Twombly* for proposition that courts deciding Rule 12(b)(6) motions are "not required to accept as true conclusory allegations and legal conclusions couched as factual allegations").[11]

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[10] This approach is consistent with that taken by other federal appeals courts, which recognize that nominal disclaimers of fraud do not preclude courts from finding that a claim sounds in fraud. *See, e.g., Rombach*, 355 F.3d at 171-72; *Anderson v. Clow (In re Stac Electronics Sec. Litig.)*, 89 F.3d 1399, 1405 n.2 (9th Cir. 1996) [hereinafter *Stac*], *cert. denied*, 520 U.S. 1103 (1997); *see also CALPERS*, 394 F.3d at 160 (pre-*Suprema* Third Circuit decision).

[11] *See also United States v. Febus*, 218 F.3d 784, 797 n.11 (7th Cir.) (describing as "conclusory" allegation that counsel "failed to investigate the facts relating to the court's enhancement of [defendant's] sentence for obstruction of justice"), *cert. denied*, 531 U.S. 1021 (2000); *United States v. Popoola*, 881 F.2d 811, 813 (9th Cir. 1989) (stating, in rejecting ineffective assistance claim, "Popoola's contention that [his lawyer] failed to investigate fingerprints, handwriting samples, and physical evidence is an

Contrary to the teachings of *Tellabs*, the Ninth Circuit standard does not allow the district court to assess all plausible inferences that may be drawn from a complaint. Instead, it asks only whether the nonfraud theory nominally asserted by the plaintiff is inconceivable, for only if the plaintiff's theory is inconceivable can fraud be the "necessar[y]" explanation underlying the plaintiff's allegations.

Together, *Twombly* and *Tellabs* counsel that as long as fraud is a plausible explanation for alleged false statements in a prospectus — and certainly where fraud is the most plausible explanation — the Sounds in Fraud Doctrine should apply and the plaintiff's claims should be tested against the requirements of Rule 9(b). In those circumstances, many readers would understand the complaint to charge the defendants with acting fraudulently, as did Judge Rymer and the district court judge (App. 3a, 5a), implicating a key rationale underlying Rule 9(b) — the need to protect defendants' goodwill and reputation. *See United States ex rel. Harrison*, 352 F.3d at 921; *Rombach*, 355 F.3d at 171.

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unsupported conclusory allegation"), *overruled on other grounds by Lozada v. Deeds*, 964 F.2d 956 (9th Cir. 1992); *McKesson HBOC*, 126 F. Supp. 2d at 1277-78 (describing as "conclusory" allegation that defendants breached fiduciary duties by, inter alia, failing adequately to investigate company's financial condition before issuing a proxy statement).

In sum, the "necessarily constitute fraud" standard does not allow for either consideration of the plausibility of a fraud explanation for false statements in a prospectus or a comparison of the plausibility of competing explanations. In these respects it is inconsistent with *Twombly* and *Tellabs*, and therefore should be rejected.

### C. The "Necessarily Constitute Fraud" Standard Conflicts With Standards Used by Other Federal Appeals Courts

Other than the panel that decided this case and *Leadis*, no federal appellate court has applied the "necessarily constitute fraud" standard to determine whether a securities law claim sounds in fraud.[12] Rather, other federal appellate courts that have applied the Sounds in Fraud Doctrine to Securities Act claims — including the Ninth Circuit, until now — have asked only whether the essence or "gravamen" of the claim is fraud. *See ACA Financial*, 512 F.3d at 68 (holding that Securities Act claim sounds in fraud because "the essence of the claim against Advest is fraud"); *Rombach*, 355 F.3d at 171-72 (applying Sounds in Fraud Doctrine to Securities Act claim "where the claims are premised on allegations of fraud" as reflected in the fact that "the wording and imputations of the complaint are classically

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[12] We have uncovered only one case other than this one and *Leadis* that has employed the "necessarily constitute fraud" standard to determine whether a Securities Act claim sounds in fraud: *In re Mikohn Gaming Corp. Sec. Litig.*, 2006 WL 2547095, *9-10 (D. Nev. Sept. 1, 2006) (unreported).

associated with fraud"); *Stac*, 89 F.3d at 1405 n.2, ("nominal efforts [to disclaim allegations of fraud] are unconvincing where the gravamen of the complaint is plainly fraud" (alteration added)).

The difference between the "necessarily constitute fraud" and "gravamen" standards is more than linguistic. The "necessarily constitute fraud" test requires a showing that fraud is the only conceivable explanation for the allegations in the complaint. In practice, it is little different in effect than the approaches taken by the Eighth Circuit, which precludes application of the Sounds in Fraud Doctrine to any Securities Act claim, and the Eleventh Circuit, which suggested that it should not apply to stand-alone Securities Act claims. *See NationsMart*, 130 F.3d at 314; *Wagner*, 464 F.3d at 1278. In contrast to the approaches taken by the Ninth Circuit and these other two courts, and consistent with the approach to pleading endorsed by this Court in *Twombly* and *Tellabs*, determining whether fraud is the essence or gravamen of a claim inherently permits the district court to consider and give effect to the existence and strength of all competing, plausible inferences.[13]

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[13] That the standards differ is also reflected in the fact that the Ninth Circuit formerly used the "gravamen" formulation, *see Stac*, 89 F.3d at 1405 n.2, but no longer does.

### D. Contrary to Congressional Intent and Public Policy, the "Necessarily Constitute Fraud" Standard Effectively Precludes Use of the Sounds in Fraud Doctrine in Stand-Alone Securities Act Cases

The Ninth Circuit's conclusion that the SAC did not sound in fraud demonstrates that the "necessarily constitute fraud" standard threatens to extinguish the availability of the Sounds in Fraud Doctrine for all Securities Act claims that are not part of a complaint that contains Exchange Act claims. Indeed, the Ninth Circuit held that allegations in the SAC did not necessarily constitute fraud despite Judge Rymer's conclusion that plaintiff's Securities Act claim "walks and talks like fraud."[14]

Considering plaintiff's allegations in the SAC, fraud is by far the most plausible explanation for the alleged misrepresentations in the Prospectus. For example:

(1) The Prospectus stated that Merix had "an expanding customer base, was experiencing an increase in 'programs' from existing customers, and was facing an increased

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[14] The district court reached a similar conclusion, ruling that after stripping from the SAC all insufficiently pled allegations of fraud, "[o]nly a few paragraphs survive that could plausibly allege negligent conduct or negligent misrepresentations or omissions," and these were "insufficient to state a claim of negligence." (App. 5a.)

demand for its products." (ER43 [¶60].) Plaintiff alleges, however, that Merix had experienced for at least four months a sustained and "precipitous" drop in product demand and orders from its customers (including its largest customers), and many customers had even cancelled orders. (ER40 [¶¶49-51], ER43-44 [¶¶60, 62(a)], ER49 [¶75(a)].)

(2) The Prospectus stated that Merix sold high-quality products manufactured to customer specifications. (ER46 [¶¶67-69].) Plaintiff alleges, however, that when Merix made this representation product defects were so serious and widespread that Merix encountered large-scale product returns (including entire orders), "customer dissatisfaction," and "impairment of business relations" with customers. (ER42 [¶58], ER53 [¶83(d)].)

(3) The Prospectus stated that Merix continued to expand its only then-operating manufacturing facility at Forest Grove (ER51 [¶79]) and expected production at its new Wood Village plant to begin in early 2004, so that production capacity would increase 50% by the end of 2004 (ER50 [¶76]). Plaintiff alleges, however, that:

- Merix "had not expanded Forest Grove" (ER51 [¶79]);

- Wood Village "was already operating by at least December 2003" (ER50 [¶¶77, 78(a)]); and
- Severe production bottlenecks — triggered by commencement of operations at Wood Village — were "stunt[ing] the Company's overall production capacity" and would prevent Merix from ever "realiz[ing] any meaningful increase in production" (ER33 [¶10(iv)], ER40 [¶56], ER51 [¶79]).

(4) Plaintiff alleges that Merix disclosed as future risks key developments that "had already come to pass and were adversely affecting Merix's business." (ER52-53 [¶¶82-83].)

(5) Plaintiff alleges that Merix improperly recognized revenue on defective goods and improperly deferred expenses in violation of Generally Accepted Accounting Principles. (ER54-55 [¶¶85-88].)

In all, plaintiff alleges in the SAC that the Prospectus contained nearly forty false statements and another twenty or so material omissions related to core elements of Merix's business.

If the facts alleged by plaintiff were true, it is highly unlikely that defendants would not have known of these and other facts that supposedly contradicted the Prospectus. This is especially true given that (a) Merix's corporate headquarters are in

Forest Grove, the site of its only plant in operation while the Prospectus was being prepared (ER38 [¶44]), (b) Merix primarily served a core group of only five main customers (of which the two most significant were alleged, in one case, to have stopped placing orders and, in the other, to have returned entire orders due to defects) (ER39 [¶47], ER40 [¶52], ER42 [¶58], ER43-44 [¶62(a)], ER44-45 [¶¶65, 66(a)]), and (c) the alleged false statements pertained to subjects — sales, customers, product quality, manufacturing plants — that comprise the lifeblood of Merix's business. *See, e.g., Berson v. Applied Signal Technology, Inc.*, 527 F.3d 982, 987 (9th Cir. 2008) (holding that plaintiff pled a strong inference of scienter, to support a Section 10(b) claim, because defendant's "high level managers must have known about [certain stop-work] orders because of their devastating effect on the corporation's revenue"); *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702, 711 (7th Cir. 2008) ("Is it conceivable that [Tellabs' CEO] was unaware of the problems of his company's two major products . . . ? It is conceivable, yes, but it is exceedingly unlikely." (alterations added)); *PR Diamonds, Inc. v. Chandler*, 364 F.3d 671, 688 (6th Cir. 2004) ("high-level executives can be presumed to be aware of matters central to their business's operation").[16]

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[16] That fraud is the real premise of the SAC is further evident from the large number of alleged false statements and material omissions cited therein. *See, e.g., Khalil v. Developers Surety & Indemnity Co. (In re Khalil)*, 379 B.R.

Despite the difficulty of "read[ing] the amended pleading in this case as claiming anything other than a classic securities fraud" (App. 3a),[16] the Ninth Circuit's "necessarily constitute fraud" standard precluded such a determination. If the SAC does not sound in fraud under this standard, then it legitimately can be asked if any complaint containing stand-alone Securities Act claims could. Effectively, the "necessarily constitute fraud" standard brings the Ninth Circuit, at least with regard to stand-alone Securities Act claims, in line with the Eighth Circuit's position that the Sounds in Fraud Doctrine does not apply to any Securities Act claims and the Eleventh Circuit's position (stated in dictum) that it should not apply to stand-

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163, 175-76 (9th Cir. BAP 2007); *cf. Holland v. United States*, 348 U.S. 121, 139 (1954) (consistent pattern of underreporting income supports inference of willfully fraudulent conduct); *Sneed v. Commissioner*, 43 T.C.M. (CCH) 1325, 1328-29 (1982) ("The contradictions and inconsistencies in petitioner's statements are too many and too serious to be attributable to an honestly faulty memory.").

[16] In this regard, the allegations of fraud in *Tellabs* are instructive. In *Tellabs*, the plaintiff alleged that the defendants misrepresented (1) customer demand for the company's "flagship" product, (2) the company's ability to deliver products to customers, (3) revenues by engaging in "channel stuffing", and (4) revenue projections by overestimating demand. 127 S. Ct. at 2505. On remand from this Court, the Seventh Circuit held that the plaintiff's claims satisfied the requirements for pleading a securities fraud claim. *Tellabs*, 513 F.3d at 712. Plaintiff's claims here are strikingly similar, albeit considerably less detailed.

alone Securities Act claims. *See NationsMart*, 130 F.3d at 314; *Wagner*, 464 F.3d at 1278.

Such judicial abrogation of the Sounds in Fraud Doctrine is improper because Congress implicitly sanctioned its use. Indeed, Congress made extensive revisions to the Securities Act in 1995 and 1998, through the Reform Act and the Securities Litigation Uniform Standards Act, Pub. L. No. 105-353, 112 Stat. 3227 (1998). In neither instance did Congress modify or limit use of the Sounds in Fraud Doctrine, signaling its intent to accept and codify the prevailing judicial interpretations. *See Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554, 562 (1991); *see also Lorillard v. Pons*, 434 U.S. 575, 580 (1978) (Congress is presumed to know of and adopt judicial interpretations of a statute that it reenacts without change).

Preserving the Sounds in Fraud Doctrine for stand-alone Securities Act claims also is consistent with public policy. Defendants alleged to have engaged in conduct plausibly (or, as here, most plausibly) explained by fraud are subject to the reputational harm Rule 9(b) is designed to prevent, even when those claims are nominally predicated on a negligence theory. *See Vess*, 317 F.3d at 1104 ("Fraud allegations may damage a defendant's reputation regardless of the cause of action in which they appear, and they are therefore properly subject to Rule 9(b) in every case."). As Judge Rymer stated below, moreover, "It's hard to say that Merix's reputational harm (which Rule 9(b) is

there to protect) is any less obvious in the amended pleading than it was in the original pleading." (App. 3a.)[17]

Accordingly, to preserve use of the Sounds in Fraud Doctrine for stand-alone Securities Act claims, consistent with Congress's implicit intent and public policy, and to establish a uniform pleading standard for applying the Sounds in Fraud Doctrine to Securities Act claims that is consistent with the requirements of *Twombly* and *Tellabs*, this Court should grant certiorari to review the "necessarily constitute fraud" standard.

### E. The Court of Appeals' Decision Was Incorrect

Contrary to the court of appeals' conclusion, the allegations of the SAC do sound in fraud — at least when evaluated under a standard consistent with *Twombly* and *Tellabs*. Unlike the very restrictive "necessarily constitute fraud" standard employed below, the "gravamen" standard used by

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[17] The concern over harm to reputation is particularly significant, even if other Circuits do not adopt the "necessarily constitute fraud" standard, because the Ninth Circuit consistently is home to either the first or second largest number of securities class action filings each year. *See, e.g.*, CORNERSTONE RESEARCH, SECURITIES CLASS ACTION CASE FILINGS, 2007: A YEAR IN REVIEW 18 (2008), http://securities.stanford.edu/clearinghouse_research/2007_YIR/20080103-01.pdf; CORNERSTONE RESEARCH, SECURITIES CLASS ACTION CASE FILINGS, 2005: A YEAR IN REVIEW 13 (2006), http://securities.stanford.edu/clearinghouse_research/2005_YIR/2006010301.pdf.

the First Circuit allows a court to apply the Sounds in Fraud Doctrine based on findings that fraud is a plausible explanation for alleged misstatements in a Prospectus that is as compelling as, or more compelling than, any competing explanation that the plaintiff may offer.

Not only is fraud a plausible explanation for the alleged misrepresentations in the Prospectus, but it is far more compelling than the inadequate investigation explanation that plaintiff summarily alleges. Indeed, it is unlikely that Merix's top corporate officers, its directors, and the professionals who helped them prepare the Prospectus would have been negligently oblivious to scores of matters affecting core aspects of Merix's business that, by plaintiff's own allegations, had been ongoing for at least four months before the Offering.

That the SAC sounds in fraud, under an appropriate standard, would have been even more apparent to the court of appeals if it had considered the fraud-based facts alleged in the FAC, rather than the SAC's contradictory, boilerplate allegation of negligence. But even without considering the FAC's allegations, the SAC makes abundantly clear that fraud is the most compelling explanation for the alleged false statements in the Prospectus.

Because the allegations of the SAC sound in fraud, they are subject to Rule 9(b). Plaintiff's decision to drop its Exchange Act claims demonstrates its own recognition that it cannot plead its claims with particularity. The district

court therefore properly dismissed the SAC with prejudice and the court of appeals erred in reversing that determination.

## CONCLUSION

The petition for a writ of certiorari should be granted.

RESPECTFULLY SUBMITTED this 22nd day of September, 2008.

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# APPENDIX

**APPENDIX "A"**

[Filed Apr. 22, 2008]

**NOT FOR PUBLICATION**

**UNITED STATES COURT OF APPEALS**

**FOR THE NINTH CIRCUIT**

| | |
|---|---|
| In re: MERIX CORPORATION SECURITIES LITIGATION | No. 06-35894 |
| CENTRAL LABORERS PENSION FUND,<br>Plaintiff-Appellant,<br>v.<br>MERIX CORPORATION, et al.,<br>Defendants-Appellees | D.C. Nos.<br>CV-04-00826-MO<br>CV-04-00859-MO<br>CV-04-00860-MO<br>CV-04-00931-MO<br><br>MEMORANDUM* |

Appeal from the United States District Court for the District of Oregon
Michael W. Mosman, District Judge, Presiding

Argued and Submitted February 8, 2008
Portland, Oregon

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* This disposition is not appropriate for publication and is not precedent except as provided by 9th Cir. R. 36-3.

Before: RYMER, T.G. NELSON, and PAEZ, Circuit Judges

Central Laborers Pension Fund (the "Fund") appeals the district court's dismissal with prejudice of the Fund's Second Consolidated and Amended Class Action Complaint ("SAC") alleging violations of Sections 12 and 15 of the Securities Act by Merix Corporation and various other individuals and companies (collectively, "Defendants"). We have jurisdiction over this appeal under 28 U.S.C. § 1291. We reverse.

The Fund is not foreclosed from making allegations or claims in the SAC that are inconsistent with or contradicted by allegations or claims made in the Fund's previous complaint. *See PAE Gov't Servs. v. MPRI, Inc.*, 514 F.3d 856, 858-60 (9th Cir. 2007).

Fraud is not an essential element of the claims raised in the SAC, and the SAC neither specifically alleges fraud, nor does it allege facts that *necessarily* constitute fraud. *See Vess v. CIBA-GEIGY Corp. USA*, 317 F.3d 1097, 1104-05 (9th Cir. 2003). Accordingly, the allegations in the SAC do not "sound in fraud" and the SAC is not required to comply with the heightened pleading requirements of Federal Rule of Civil Procedure 9(b). *See id.*

We have considered and reject the additional arguments raised by Defendants.

REVERSED AND REMANDED.

RYMER, Circuit Judge, concurring.

I concur because the majority's is a fair read of *Vess v. CIBA-GEIGY Corp. USA*, 317 F.3d 1097, 1104-05 (9th Cir. 2003), and *PAE Gov't Servs., Inc. v. MPRI, Inc.*, 514 F.3d 856, 858-60 (9th Cir. 2007). That said, it is unclear to me how *Vess* — which is not a securities case — melds with *In re Stac Elec. Sec. Litig.*, 89 F.3d 1399 (9th Cir. 1996), and *In re Daou Sys., Inc.*, 411 F.3d 1006 (9th Cir. 2005) — which are. It is also difficult to square the strict liability nature of a Section 12 and 15 Securities Act violation with a *Vess* or *Stac* analysis. And it is tough to read the amended pleading in this case as claiming anything other than a classic securities fraud. For sure the magic words are missing, and the plaintiff is the master of the complaint; still the scheme alleged in the amended pleading walks and talks like fraud, as did the scheme averred in the original pleading. It's hard to say that Merix's reputational harm (which Rule 9(b) is there to protect) is any less obvious in the amended pleading than it was in the original pleading. Perhaps it is time we tried to straighten our law out.

**APPENDIX "B"**

[Filed Sept. 28, 2006]

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF OREGON

| | |
|---|---|
| In re: MERIX CORPORATION SECURITIES LITIGATION | Lead Case No. CV04-826-MO (Consolidated Cases) |
| This Document Relates to: ALL ACTIONS | ORDER DISMISSING PLAINTIFFS' SECOND AMENDED COMPLAINT |

**MOSMAN, J.,**

This is a consolidated securities class action alleging claims under §§ 11, 12(a)(2), and 15 of the Securities Act of 1933. Plaintiffs principally allege they purchased stock from Merix's secondary public offering (SPO) and that Merix's SPO Prospectus contained materially false and misleading statements and omitted material facts necessary to avoid making misleading statements. Plaintiffs also allege underwriter defendants, as sellers of the security, are liable under § 12(a)(2) and that individual directors and officers are liable as controlling individuals under § 15. Now pending before the court are defendants' motions to dismiss

(#89, #91), plaintiffs' request for judicial notice (#98), and plaintiffs' motion to file a surreply (#104).

After carefully considering the parties' moving papers, and with the benefit of extensive oral argument, defendants' motions to dismiss are GRANTED.

For the reasons stated on the record and in accordance with *In re Daou Systems, Inc. Secs. Litig.*, 411 F.3d 1006, 1028 (9th Cir. 2005), the court has stripped plaintiffs' §§ 11 and 12(a)(2) claims of all allegations of fraud insufficiently plead under Rule 9(b). Only a few paragraphs survive that could plausibly allege negligent conduct or negligent misrepresentations or omissions. Standing alone, these few paragraphs are insufficient to state a claim of negligence. *Id.* Because plaintiffs' § 15 claim is predicated upon liability under §§ 11 or 12, it is also necessarily dismissed.

Plaintiffs have now failed for the second time to meet the heightened pleading standard of Rule 9(b). The court finds that any further attempt to amend the complaint would be futile. Accordingly, plaintiffs' second amended complaint (#85) is DISMISSED WITH PREJUDICE.

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Plaintiffs' request for judicial notice (#98) and plaintiffs' motion to file a surreply (#104) are therefore DENIED as moot.

IT IS SO ORDERED.

DATED this 28th day of September, 2006.

/s/ Michael W. Mosman
MICHAEL W. MOSMAN
United States District Court

**APPENDIX "C"**

[Filed Sept. 15, 2005]

UNITED STATES DISTRICT COURT

DISTRICT OF OREGON

| | |
|---|---|
| CENTRAL LABORERS PENSION FUND,<br>Plaintiff,<br>v.<br>MERIX CORPORATION, et al.,<br>Defendants(s) | No. CV04-826-MO<br><br>OPINION AND ORDER |

**MOSMAN, J.**

Central Laborers Pension Fund, Lead Plaintiff in four consolidated securities class actions, brought suit against Merix Corporation ("Merix" or "the Company") and four of Merix's officers[1] (collectively, the "Merix Defendants") alleging securities fraud under Section 10(b) of the Securities Exchange Act of 1934[2] and SEC Rule

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[1] The Merix officers are CEO Mark Hollinger, CFO Janie Brown, Senior Vice President for Operations Anaya Vardya and Senior Vice President for Sales Daniel Olson (collectively, the "Officer Defendants").

[2] 15 U.S.C. § 78j(b) ("Exchange Act").

10b-5[3] for allegedly false and misleading public statements these defendants made between October 14, 2003 and May 29, 2004 (the "Class Period"). Plaintiff also asserts claims against the Officer Defendants under Section 20(a) of the Exchange Act[4] and Section 15 of the Securities Act of 1933[5] on the grounds that they are "control persons" over Merix and therefore liable to the extent Merix may be found liable for a primary violation of the securities laws. Finally, Plaintiff brings claims under Sections 11 and 12(a)(2) of the Securities Act against Defendants Merix, Hollinger, Brown, seven of Merix's directors, and six underwriters (the "Underwriter Defendants")[6] for allegedly false and misleading statements appearing in a January 28, 2004 Prospectus (the "Prospectus") issued in connection with a secondary public offering of Merix shares.

Before the court are the Merix and Underwriter Defendants' motions to dismiss Plaintiff's amended complaint under Federal Rules of Civil Procedure 12(b)(6) and 9(b). As set forth below, Defendants' motions (# 47 and # 49) are GRANTED. With respect to the Merix Defendants,

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[3] 17 C.F.R. § 240.10b-5.

[4] 15 U.S.C. § 78t(a).

[5] 15 U.S.C. § 77o ("Securities Act").

[6] The Underwriter Defendants include UBS Securities LLC ("UBS"), Thomas Weisel Partners LLC ("Thomas Weisel"), Needham & Company, Inc. ("Needham"), Wells Fargo Securities, LLC ("Wells Fargo"), Raymond James & Associates, Inc. ("Raymond James"), and William Blair & Company, LLC ("William Blair").

Plaintiff failed to plead its fraud claims with the particularity required under Rule 9(b) and the Private Securities Reform Act of 1995, 15 U.S.C. § 78u-4 ("PSLRA" or "Reform Act"). Specifically, Plaintiff's complaint fails to identify with particularity the alleged misstatements and omissions upon which its claims rest, the reasons for their falsity, or their materiality. Furthermore, because Plaintiff's claims under Sections 11 and 12(a)(2) sound in fraud, Rule 9(b) applies to these claims as well. However, Plaintiff has failed to plead these claims against the Merix Defendants with the requisite particularity. Finally, Plaintiff has failed to allege facts sufficient to state a claim against Defendants Merix, Hollinger and Brown under Section 12(a)(2). Accordingly, Plaintiff's claims against the Merix Defendants are dismissed with leave to re-plead.

With respect to Plaintiff's Section 11 and 12(a)(2) claims against the Underwriter Defendants, Plaintiff has failed to plead with particularity the alleged false statements and omissions that form the bases of its claims, and has failed to plead sufficient facts to create an inference that the omissions Plaintiff complains of rendered the Prospectus false. Accordingly, these claims are dismissed without prejudice. In addition, to the extent Plaintiff's Section 12(a)(2) claim against the Underwriter Defendants is brought on behalf of anyone other than investors who purchased Merix securities directly from the Underwriter Defendants pursuant to the Prospectus, that claim is dismissed with prejudice for lack of standing.

## I. Plaintiff's claims[7]

Merix is a manufacturer of complex multi-layer printed circuit boards ("PCBs") used to interconnect components of electronic products and systems. Merix's services include "quick-turn" prototyping, compressed lead-time volume services (which it refers to as "premium services"), and volume production of PCBs. Merix's quick-turn and premium services "are used in the design, test and launch phases of new electronic products and require rapid manufacturing, with industry delivery times ranging from as little as 24 hours to as long as 10 days." Compl. at ¶43. Merix receives a premium over the normal PCB price for its quick-turn and premium products. Merix's standard volume manufacturing services "are needed as a product progresses past the testing and design phases and into pre-production and then volume production." *Id.*

Prior to and during the Class Period, Merix was headquartered at a 73-acre campus in Forest Grove, Oregon. During that period Merix was also engaged in constructing a new facility in Wood Village, Oregon. The Company's five largest customers during the Class Period were Cisco Systems ("Cisco"), Motorola, Ericsson, Juniper Networks, and Nokia. In fiscal 2002 and 2003,

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[7] On Defendants' motion to dismiss, the court presumes all factual allegations of the complaint to be true. *Usher v. City of L.A.*, 828 F.2d 556, 561 (9th Cir. 1987). Accordingly, the following facts are taken from Plaintiff's amended complaint.

Cisco and Motorola each accounted for more than 10% of Merix's net sales.

Plaintiff alleges that during the Class Period, the Merix Defendants made "three main categories" of materially false and misleading statements. Pl.'s Br. at 5. The first category involves the Company's reported results of operations, including the repeated representation that such results were prepared in accordance with Generally Accepted Accounting Principles ("GAAP"). Plaintiff avers that Merix's revenues, earnings, and other reported financial metrics were grossly inflated throughout the Class Period because the Merix Defendants improperly recognized revenue for products they knew were defective and likely to be returned, in violation of GAAP. Second, Plaintiff alleges the Merix Defendants repeatedly asserted that demand for the Company's products was increasing and that Merix was increasing its market share, when in fact "major Merix customers began canceling orders as early as November of 2003." *Id.* at 6. Finally, Plaintiff alleges the Merix Defendants falsely claimed that its new Wood Village facility would increase its output capacity by up to 50 percent by the end of calendar 2004, and was "key" to the Company's ability to grow its "quick-turn" and premium services.

Plaintiff alleges that these false statements "conditioned the market," artificially inflating Merix's stock price. The Merix and Underwriter Defendants took advantage of the inflated price by

executing a secondary offering of Merix stock in January 2004. In conjunction with that offering the Defendants issued a Prospectus containing materially false or misleading statements falling within the same categories identified above. In addition, Plaintiff alleges the Officer Defendants took advantage of the inflated stock price by engaging in insider sales of Merix's common stock throughout the Class Period.

On May 13, 2004, Merix revised downward the Company's guidance for the fourth quarter of fiscal 2004, which ended May 29, 2004. The Company announced that positive earnings previously forecasted to come in between $0.19 and $0.22 per diluted share were now expected to be a loss of ($0.03) to ($0.06) per share. The Company cited a "lower level of premium services business attributed to reduced demand by customers for expedited volume orders and reduced orders from a major customer" as the reasons for the decreased forecast. The Company further disclosed the detection of a "manufacturing process error" that affected three high volume part numbers with significant quantities scheduled for shipment in the fourth quarter. The Company announced that although replacement parts were being built, they would not be completed and shipped until the following quarter. Following the May 13, 2004 announcement, the price of Merix's stock dropped more than 30 percent — from $15.32 to $10.68 per share — in one day, resulting in a market capitalization loss of more than $90 million.

## II. Merix Defendants

### A. Section 10(b) fraud claim

#### 1. Pleading standard

In ruling on a motion to dismiss for failure to state a claim, "the court must presume all factual allegations of the complaint to be true and draw all reasonable inferences in favor of the nonmoving party." *Usher*, 828 F.2d at 561 (citation omitted). "A motion to dismiss for failure to state a claim may not be granted unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Knevelbaard Dairies v. Kraft Foods, Inc.*, 232 F.3d 979, 984 (9th Cir. 2000) (internal quotations and citation omitted). "Nonetheless, conclusory allegations without more are insufficient to defeat a motion to dismiss for failure to state a claim." *McGlinchy v. Shell Chem. Co.*, 845 F.2d 802, 810 (9th Cir. 1988).

To state a claim for securities fraud under Section 10(b) and Rule 10b-5, Plaintiff must allege: "(1) a misstatement or omission (2) of material fact (3) made with scienter (4) on which [Plaintiff] relied (5) which proximately caused [Plaintff's] injury." *DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385, 388 (9th Cir. 2002). Generally, the Federal Rules of Civil Procedure "do not require a claimant to set out in detail the facts upon which he bases his claim." *Conley v. Gibson*, 355 U.S. 41, 47, 78 S. Ct. 99, 2 L. Ed. 2d 80 (1957). Rather, a complaint need only provide "a short and plain

statement of the claim that will give the defendant fair notice of what the plaintiff's claim is and the grounds upon which it rests." *Id.* However, Federal Rule of Civil Procedure 9(b) requires that "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." The PSLRA likewise provides that a complaint must "specify each statement alleged to have been misleading, [and] the reason or reasons why the statement is misleading." 15 U.S.C. § 78u-4(b)(1). Where an allegation is made on information and belief, the Act requires that "the complaint shall state with particularity all facts on which that belief is formed." *Id.* This requires plaintiff to "provide a list of all relevant circumstances in great detail." *In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 984 (9th Cir. 1999). Finally, where, as here, a defendant's mental state is an element of plaintiff's claims, "the complaint shall, with respect to each act or omission . . . state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2).

**2. False or misleading statements**

To allege falsity under Rule 9(b) and the PSLRA, a complaint must set forth: "(1) each statement alleged to have been misleading; (2) the reason or reasons why the statement is misleading; and (3) all facts on which that belief is formed." *Desaigoudar v. Meyercord*, 223 F.3d 1020, 1023 (9th Cir. 2000). Despite a voluminous 110-page complaint, Plaintiff fails to identify with

particularity each allegedly misleading statement upon which Plaintiff's claims rest. While the complaint lists countless statements by the Merix Defendants, it does not identify which of these are allegedly false. For example, paragraph 60 of the complaint notes that Merix's January 6, 2004, Form 10-Q contained several statements. It does not state which of these statements, if any, were allegedly false.[8] Portions of some of the statements cited in the complaint are written in boldface, with the possible implication that the bold portions constitute the allegedly false statements. However, Plaintiff's memorandum in opposition to Defendants' motion identifies only non-bold statements as examples of the complaint's "specific statements made by the Defendants . . . that were false and misleading."[9] Indeed, after reading

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[8] *See also* Compl. at ¶54 ("the Form 10-Q . . . provided, in part . . ."); ¶62 ("The release stated in part . . .").

[9] *See* Pl.'s Br. at 14 (citing: (1) non-bold statement in ¶54 that "[n]et sales were $30.7 million in the first quarter of fiscal 2004;" (2) non-bold statement in ¶55 that sales for the second quarter of fiscal 2005 were $37 million and that net income was $0.05 per diluted share; (3) non-bold statement in ¶60 that "[g]ross margin as a percentage of net sales was 14.9% . . . in the second quarter of fiscal 2004; and (4) non-bold statement in ¶75 that sales for the third quarter of fiscal 2004 were $44.1 million and that net income was $0.19 per diluted share); *see also In re Splash Tech. Holdings Secs. Litig.*, 160 F. Supp. 2d 1059, 1074-75 (N.D. Cal. 2001) ("The fact that certain sections of the report have been highlighted is not a reliable guide to determining which statements are alleged to be false, as bolded statements sometimes do not turn out to be actionable, while non-bolded statements sometimes are actionable.").

Plaintiff's memorandum it is less clear whether Plaintiff is asserting that each and every statement cited in the complaint is false and misleading[10] or, if less than all of the statements, which of the numerous statements form the basis of Plaintiff's claims.

Absent such particularity, the complaint necessarily fails to identify the reasons why each such statement is misleading. For example, in its memorandum in opposition to Defendants' motion, Plaintiff identifies "Defendants' boastful statements concerning the Wood Village facility and its expected impact on the Company's financial condition" as one of the "categories" of false or misleading statements alleged in the complaint. Pl.'s Br. at 6. Plaintiff argues Defendants made false or misleading statements to the effect that Merix expected to use Wood Village to perform premium services and quick turn work, despite the fact that the facility was not designed to perform such work. *Id.* at 7. But Plaintiff does not identify, nor could the court locate, any statement by the Defendants alleged in the complaint to the effect that Merix would use Wood Village to perform premium services and quick turn work. The statements upon which Plaintiff relies state only that "[w]e expect the first phase of our expansion

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[10] This would include, for example, such statements as "[i]n September 2003, we announced our plans to complete the first phase of the capacity expansion program at our Wood Village, Oregon facility." Compl. at ¶54. It appears doubtful, but by no means certain, that Plaintiff is alleging that Merix did not make this announcement in September 2003.

[of Wood Village] . . . to significantly enhance our quick-turn and premium services capability." Compl. at ¶60. This statement does not claim that the Wood Village facility would perform these services. In fact, in one of the statements cited by Plaintiff, Defendant Olson states that "[t]he sales organization is very excited about the commencement of operations in Wood Village since we were able to transfer volume production to that facility, which frees up capacity at Forest Grove for quick-turn and premium services orders." *Id.* at ¶78. The contrast between Plaintiff's characterization of the "category" of Defendants' alleged Wood Village misrepresentations and the actual statements identified in the complaint highlights the necessity of specifically identifying the statements upon which Plaintiff's claims rest and the reasons why each such statement is false. Plaintiff cannot meet the heightened pleading standards applicable to fraud claims by simply characterizing Defendants' statements, embedding in those characterizations assumptions not found in the statements themselves, and then explaining why Plaintiff's own assumptions are false.

"In short, plaintiffs have left it up to defendants and the court to try to figure out exactly what the misleading statements are, and to match the statements up with the reasons they are false or misleading." *In re Autodesk, Inc. Sec. Litig.*, 132 F. Supp. 2d 833, 842 (N.D. Cal. 2000). As such, Plaintiff's complaint fails to satisfy the pleading requirements of the PSLRA. 15 U.S.C. § 78u-4(b)(1). In addition, the court cannot assess the

materiality of any allegedly false statements without knowing the precise statements at issue. The court likewise cannot rely on Plaintiff's characterization of Defendants' statements to determine whether they are subject to the PSLRA's safe harbor for forward-looking statements,[11] or whether Defendants acted with scienter in making those statements. *See, e.g., In re Daou Sys. Inc.*, 411 F.3d 1006, 1015 (9th Cir. 2005) ("falsity and scienter in private securities fraud cases are generally strongly inferred from the same set of facts, and the two requirements may be combined into a unitary inquiry under the PSLRA." (internal quotations and citation omitted)). Accordingly, Plaintiff's fraud claims are dismissed with leave to re-plead.

**B. Claims under Sections 11(a) and 12(a)(2)**

**1. Pleading standard**

Plaintiff seeks to hold the Merix Defendants liable under Sections 11 and 12(a)(2) of the Securities Act for their role in the issuance of the January 2004 Prospectus in conjunction with a secondary offering of Merix stock. Section 11 of the Securities Act imposes liability when "any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. § 77k(a). Thus, to state a claim under Section 11, a

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[11] *See* 15 U.S.C. § 78u-5(c).

plaintiff must demonstrate "'(1) that the registration statement contained an omission or misrepresentation, and (2) that the omission or misrepresentation was material, that is, it would have misled a reasonable investor about the nature of his or her investment.'" *In re Daou Sys.*, 411 F.3d at 1027 (quoting *In re Stac Elecs. Sec. Litig.*, 89 F.3d 1399, 1403-04 (9th Cir. 1996)). Section 12(a)(2) of the Securities Act imposes civil liability on any person who sells securities through the use of certain instruments, including a prospectus, containing material misstatements or omissions. 15 U.S.C. § 771(a)(2). To establish liability under section 12(a)(2), a plaintiff must allege that the defendants "solicited purchase of the securities for their own financial gain." *In re Daou Sys.*, 411 F.3d at 1029.

Unlike claims under Section 10(b), claims under Sections 11(a) and 12(a)(2) do not contain an element of fraud. *Id.* at 1027. As such, these claims typically are subject to Federal Rule of Civil Procedure 8(a)'s requirement of "a short and plain statement of the claim." However, where Plaintiff's claims "sound in fraud," the heightened requirements of Rule 9(b) apply, requiring Plaintiff to plead its allegations with particularity. *In re Daou Sys.*, 411 F.3d at 1027. Where a plaintiff chooses "not to allege a unified course of fraudulent conduct in support of a claim, but rather to allege some fraudulent and some non-fraudulent conduct . . . only the allegations of fraud are subject to Rule 9(b)'s heightened pleading requirements." *Vess v. Ciba-Geigy Corp. USA*, 317 F.3d 1097, 1104 (9th

Cir. 2003). In those situations, the court disregards the fraud allegations in construing the Securities Act claims and evaluates whether Plaintiff has stated a claim in the absence of those allegations under Rule 8(a). Where, however, the plaintiff alleges "a unified course of fraudulent conduct" and relies on that conduct as the basis of its Securities Act claim, "the claim is said to be 'grounded in fraud' or to 'sound in fraud,' and the pleading of that claim as a whole must satisfy the particularity requirement of Rule 9(b)." *Id.*

In the instant action, Plaintiff argues that because its Securities Act claims expressly disclaim any assertion that Defendants are liable under that Act for fraudulent or intentional conduct, these claims necessarily do not sound in fraud. However, "[t]hese nominal efforts are unconvincing where the gravamen of the complaint is plainly fraud and no effort is made to show any other basis for the claims levied at the Prospectus." *In re Stac Elecs.*, 89 F.3d at 1405 n.2. The substance of the alleged misrepresentations and omissions that form the basis of Plaintiff's Securities Act claims is virtually identical to that of the statements underlying its Exchange Act claims — namely, exaggerated customer demand, overstated earnings, and overly optimistic statements about the Wood Village facility. Plaintiff does not explain how misstatements knowingly made before and after issuance of the Prospectus could have been merely negligently made in relation to the Prospectus — particularly when the complaint alleges that the Prospectus incorporated by reference Merix's

previously announced financial information. *See* Compl. at ¶168; *see also In re Metricom Sec. Litig.*, No. C01-4085 PJH, 2004 WL 966291, at *24 (N.D. Cal. Apr. 29, 2004) ("Plaintiffs cannot allege fraud based on a series of events occurring before the offering and on essentially identical events continuing after the offering, and then scissor out a non-fraud claim from the center of that unified course of conduct in order to evade the Rule 9(b) requirement."). Because Plaintiff's Securities Act claims sound in fraud, Plaintiff must plead these claims with the particularity required under Rule 9(b).

As noted above, Plaintiff's complaint fails to identify with particularity the alleged misstatements and omissions upon which its claims rest, the reasons for their falsity, or their materiality. Accordingly, Plaintiff's Securities Act claims against the Merix Defendants are likewise dismissed with leave to re-plead.

**2. Plaintiff's Section 12 claims against Merix, Hollinger and Brown**

Section 12(a)(2) provides that "[a]ny person who offers or sells a security" by means of a misleading prospectus "shall be liable . . . to the person purchasing such security from him." 15 U.S.C. § 771(a)(2). The Merix Defendants move to dismiss Plaintiff's Section 12 claims against Merix, Hollinger and Brown on the grounds that they are not "sellers" as contemplated by that section. The court agrees.

Plaintiff appears to argue that Merix is liable as a seller because it was Merix's stock that was sold in the January offering. Simply put, this is not the law. In *Pinter v. Dahl*, 486 U.S. 622, 108 S. Ct. 2063, 100 L. Ed. 2d 658 (1988), the Supreme Court determined that Section 12 "imposes liability on only the buyer's immediate seller; remote purchasers are precluded from bringing actions against remote sellers. Thus, a buyer cannot recover against his seller's seller." *Id.* at 643 n.21. In the instant action, Merix sold its shares to the Underwriter Defendants pursuant to a "firm commitment" underwriting — i.e., "one in which the underwriter agrees to buy all the shares to be issued and remains financially responsible for any securities not purchased." *In re Infonet Servs. Corp. Secs. Litig.*, 310 F. Supp. 2d 1080, 1100 (C.D. Cal. 2003). "[I]n a firm commitment underwriting . . . the public cannot ordinarily hold the issuers liable under section 12, because the public does not purchase from the issuers. Rather, the public purchases from the underwriters, and suing the issuers is an attempt to recover against the seller's seller." *Lone Star Ladies Inv. Club v. Schlotzsky's Inc.*, 238 F.3d 363, 370 (5th Cir. 2001) (internal quotations and citation omitted). Accordingly, Plaintiff cannot hold Merix liable simply because Merix originally sold to the Underwriters the stock that Plaintiff purchased from the Underwriters.

That said, it is also true that an individual need not have actually passed title to a purchaser in order to be deemed a "seller" under Section 12. Rather, that designation also applies to any

individual who "successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner." *Pinter*, 486 U.S. at 647. The *Pinter* Court identified "a securities vendor's agent who solicited the purchase" as an example of a person who "would be commonly said, and would be thought by the buyer, to be among those 'from' whom the buyer 'purchased,' even though the agent himself did not pass title." *Id.* at 644. However, the Court expressly rejected the contention that Section 12 imposed liability for "mere participation" in unlawful sales transactions, even if that participation constitutes "a substantial factor in causing the transaction to take place." *Id.* at 649.

The only argument Plaintiff submits in support of the contention that the Merix Defendants may be held liable as sellers is that "Hollinger and Brown, as signatories to the January Prospectus, are solicitors pursuant to Section 12(a)(2)." The Ninth Circuit has not addressed whether merely signing a Prospectus constitutes active solicitation sufficient to render the signatory a "seller" under 12(a)(2). While district courts are split on this issue,[12] every Circuit

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[12] *Compare In re Stratosphere Sec. Litig.*, 1 F. Supp. 2d 1096, 1120 (D. Nev. 1998) ("merely providing that Defendants signed the allegedly misleading registration statement or prospectus for a firm commitment offering is insufficient to prove that Defendants were sellers under section 12"), *and In re Infonet Servs.*, 310 F. Supp. 2d at 1101 (same), *with In re Sirrom Capital Corp. Sec. Litig.*, 84 F. Supp. 2d 933, 945 (M.D. Tenn. 1999) (concluding that because

to have addressed the issue has determined that simply signing a registration statement or prospectus is an insufficient legal basis for relief.[13]

This conclusion is in accord with the *Pinter* Court's determination that the fact that an individual's activities constitute a "substantial factor" in a sale of securities is insufficient to render that individual a seller under Section 12. *Pinter*, 486 U.S. at 649-50. In addition, to hold otherwise would erase a critical distinction between Section 11, which expressly imposes liability on any individual who signs a false or misleading registration statement, 15 U.S.C. § 77k(a)(1), and

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"[a] Prospectus itself is considered a solicitation document. . .. Defendants who actually signed the Registration Statements may be said to have solicited the public to purchase the stock."), *and Degulis v. LXR Biotechnology, Inc.*, 928 F. Supp. 1301, 1315 (S.D.N.Y. 1996) (denying motion to dismiss because "[a]lthough signing the registration statement need not constitute active solicitation, it is, at this stage of the proceedings, a sufficient allegation to permit Plaintiffs to present evidence that, alone or in tandem with other acts, the signatures constituted active solicitation.") (citation omitted).

[13] *See Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 871 (5th Cir. 2003) (rejecting the contention that "signing the registration statement suffices for solicitation," and holding that "[t]he issuer may only be liable under § 12(a)(2) if the plaintiff alleges that an issuer's role was not the usual one; that it went farther and became a vendor's agent." (internal quotation omitted)); *Craftmatic Sec. Litig. v. Kraftsow*, 890 F.2d 628, 636 (3d Cir. 1989) (an issuer is not liable "solely on the basis of its involvement in preparing the prospectus. The purchaser must demonstrate direct and active participation in the solicitation of the immediate sale to hold the issuer liable as a § 12(2) seller.").

Section 12, which imposes liability only on an individual who "offers or sells" a security. 15 U.S.C. § 771(a)(2). As the *Pinter* Court noted:

> Section 11(a) explicitly enumerates the various categories of persons involved in the registration process who are subject to suit under that section, including many who are participants in the activities leading up to the sale. There are no similar provisions in § 12, and therefore we may conclude that Congress did not intend such persons to be defendants in § 12 actions.

486 U.S. at 650 n. 26.

Moreover, because of the routine nature of an issuer signing a prospectus, imposing Section 12 liability solely on the basis of an issuer's preparation of a prospectus would ignore the *Pinter* Court's declaration that "a buyer cannot recover against his seller's seller." *Id.* at 644 n. 21. As the Fifth Circuit stated, "[v]irtually all issuers routinely promote a new issue, if only in the form of preparing a prospectus and conducting a road show." *Lone Star Ladies*, 238 F.3d at 370. If such participation in an offering sufficed to create Section 12 liability, stock purchasers could bring suit against issuers as a matter of course, even in the absence of having purchased the securities directly from the issuers.

This is particularly true where, as here, an issuer sells stocks to an underwriter through a firm commitment underwriting. Where the issuer does not pass title to a buyer, the issuer is subject to liability only when it actively solicits the sale and is "motivated at least in part by a desire to serve his own financial interests or those of the securities owner." *Pinter*, 486 U.S. at 647. In a firm underwriting arrangement, however, the issuer realizes all of its profits from the offering by selling its shares to the underwriter, leaving the underwriter with responsibility for selling its shares to investors. The issuer therefore largely lacks the financial incentive to solicit further sales.

Accordingly, this court follows the weight of the authority finding that merely signing a prospectus does not qualify as soliciting a sale of securities sufficient to render an individual a seller for purposes of Section 12(a)(2). Because Plaintiff has asserted no other basis for Section 12 liability against Defendants Merix, Hollinger and Brown, this claim is dismissed against them with leave to re-plead.

## III. Underwriter claims

### A. Pleading standard

Plaintiff asserts claims against the Underwriter Defendants under Sections 11 and 12(a)(2) of the Securities Act based on alleged misstatements and omissions in the January 28, 2004, Prospectus. As noted above, because Plaintiff's claims sound in fraud, they are subject to

the heightened pleading standards of Rule 9(b). Accordingly, Plaintiff must identify each allegedly false statement or omission made by Defendants and "set forth an explanation as to why the statement or omission complained of was false or misleading . . . *when made.*" *In re Stac Elecs.*, 89 F.3d at 1404 (emphasis in original) (internal quotation omitted).

**B. False or misleading statements or omissions in the January Prospectus**

Plaintiff's Securities Act claims against the Underwriter Defendants suffer from the same infirmities as its claims against the Merix Defendants. The complaint quotes numerous passages found in the January 2004 Prospectus, highlighting portions thereof in bold print, but fails to identify which of these statements are alleged to have been false. The complaint therefore necessarily fails to articulate the reasons why such statements were false, as well as any basis for deeming such misstatements or omissions material. Accordingly, dismissal is appropriate on this basis alone.

While Plaintiff's complaint is deficient, Plaintiff's brief in opposition to the Underwriter Defendants' motion to dismiss does clearly identify six allegedly material facts omitted from the Prospectus. As set forth below, the court finds that even if these alleged omissions had been properly pled in the complaint, they are insufficient to meet the heightened pleading requirements of Rule 9(b).

**1. The Company's Wood Village facility was strictly used for certain volume orders and, thus, could not "significantly enhance [Merix's] quick-turn and premium services capabilities."**

The allegation that failing to disclose this fact constitutes a material "omission" appears to rest on the assumption that the only way Wood Village could "significantly enhance [Merix's] quick-turn and premium services capabilities" would be for Wood Village itself to perform these functions. Plaintiff identifies no statement to that effect in the Prospectus. To the contrary, the Prospectus states that Merix was expanding its existing Forest Grove facility as well, and that Merix was "significantly enhancing [its] high-end manufacturing capacity by expanding our Forest Grove and Wood Village facilities." *See* Prospectus at p. 25; *see also id.* at pp. 2, 18. Plaintiff's complaint itself acknowledges that Merix sought to enhance its capacity for quick-turn and premium services orders by transferring volume work to Wood Village, thereby freeing up capacity at the Forest Grove facility for high-end work. Compl. at ¶78. Plaintiff's conclusory allegation therefore does not create an inference that the claimed omission rendered the Prospectus false.

**2. Wood Village was hardly a "state-of-the-art" PCB manufacturing facility, as Wood Village operations included only: pre-**

> **cleaning, lamination, imaging, and DES (developing, etching and stripping) — forcing Merix to ship the unfinished boards to the Forest Grove facility where they were (1) prepared for press lamination, (2) pressed, (3) optimized, (4) drilled, (5) chemically scrubbed, (6) plated, (7) surfaced and (8) finished.**

Again, the allegation that failing to disclose these facts constitutes a material "omission" is purely conclusory. No allegation in Plaintiff's complaint creates an inference that in referring to the Wood Village facility as "state-of-the-art," the Prospectus created a false impression that the facility would be used for all stages of production, or that a facility must operate in that manner to earn the label "state-of-the-art."

> **3. Wood Village could not have increased the Company's output by "50% by the end of calendar 2004" as two operational "bottle-necks" in the plating and drilling departments at the Company's Forest Grove facility prevented such an increase.**

This alleged omission fails for several reasons. First, the allegation misrepresents the statements that actually appear in the Prospectus. Nowhere does the Prospectus state that Wood Village would increase the Company's "output" by

the end of calendar 2004. Rather, the Prospectus repeatedly states that Merix expected the Wood Village facility to increase Merix's "production capacity" by that amount. Because the complaint does not identify any claim in the Prospectus that Wood Village would increase Merix's output by the end of 2004, the alleged failure to state that Wood Village could not do so cannot constitute a material omission.

Second, the complaint contains no allegation that Wood Village did not in fact increase Merix's production capacity by 50% by the end of 2004. Plaintiff's conclusory allegation that such an increase was not possible is no substitute for a factual allegation that the increase did not in fact occur — i.e., that the statements in the Prospectus were actually false. Nor could Plaintiff's amended complaint, filed in November 2004, have contained any such allegation. Neither do the confidential witnesses upon whom Plaintiff relies, identified as W-2 and W-9, lend this claim any support, since they left Merix's employ in February and June of 2004, respectively.

Finally, absent particularized allegations that the statements regarding Wood Village's potential for adding to Merix's capacity by the end of calendar 2004 were false, Plaintiff's complaint necessarily fails to explain how the Underwriter Defendants could have known they were false in January of 2004.

4. **Demand for Merix's "quick-turn," premium services and volume**

**business had been decreasing materially since at least October 2003 and the Company's top customer — Cisco — had dramatically reduced its orders from the Company due to excessive inventory held by its electronic manufacturing service provider, Solectron.**

**a. Demand generally**

The Prospectus stated:

- Our net sales were $37.0 million in the second quarter of fiscal 2004, an increase of 43% from net sales of $25.9 million in the second quarter of fiscal 2003. The increased net sales primarily resulted from an increase in unit shipments.[14]

- Unit shipments were 47% higher in the second quarter of fiscal 2004 compared to the same period in the prior year. Unit shipments were 55% higher in the first six months of fiscal 2004 compared to the first six months of fiscal 2003. The increase in volume was the result of increased end market demand as well as new program gains

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[14] Compl. at ¶168.

> from existing customers and the addition of new customers.[15]

Plaintiff claims these allegations — and the other statements in the Prospectus referencing this alleged increase in demand[16] — are false or misleading because they failed to disclose that Merix had in fact begun to experience a decline in orders at some time between October 2003 and the end of the third fiscal quarter of 2004. Plaintiff's allegation rests upon a series of claims by confidential witnesses who recalled a slowdown in both volume and quick-turn orders:

- By October 2003, W-1 "noticed an abrupt decline in orders on the daily rosters." Whereas previously there had been "mostly" larger orders for 100 or 200 flats at a time, by October 2003 there were "rarely" large orders

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[15] *Id.*

[16] *See, e.g., id.* at ¶169: We believe end market demand increased primarily due to the economic expansion of the markets we serve, particularly the communications market. . .. We have also increased unit shipments. . .. We saw a strengthening of average pricing late in the second quarter of fiscal 2004 primarily as a result of increased demand for premium services as well as other product mix changes. . .. The increase in compressed lead-time volume orders is primarily the result of higher customer demand combined with longer standard lead-times. The level of prototype orders increased significantly compared to the prior year quarter due to our focus on growing this business. Although we expect quick-turn and premium services sales to continue to increase in dollar terms, the percentage of our net sales from these services will fluctuate.

for 100 or more flats. In fact, the "typical" order size was four or five flats at a time and "printers were often allowed to go home early due to a lack of work." Compl. at ¶90.

- "W-1 also began noticing order cancellations in November 2003, such that orders often were recalled and pulled from the process line." *Id.* at ¶91.
- W-2 stated that: "no later than November 2003, Merix experienced a precipitous drop off in PCB layer counts, thereby indicating that quick-turn and premium manufacturing was suffering." *Id.* at ¶92.
- "W-3 confirmed a noticeable sales slowdown . . . no later than early 2004." *Id.* at ¶97.
- "Nokia, a major Merix customer, experienced a large layoff in early 2004, which cut its PCB orders with Merix." *Id.*
- "Merix's largest customer, Cisco, delayed and cancelled numerous quick-turn prototype orders in the third fiscal quarter 2004." *Id.*

Each of these allegations lacks particulars regarding either the amount of any decline in orders, the timing of such a decline, or both. The

allegations that orders were "often" recalled, and that Merix experienced a "precipitous drop off in layer counts" beginning in November 2003 are insufficient to create an inference that overall demand had declined by a material amount, or that such decline persisted through the issuance of the Prospectus on January 28, 2004. The allegation that "W-3 confirmed a noticeable sales slowdown . . . no later than early 2004" likewise seeks to substitute an adjective ("noticeable") for a noun (e.g., an approximate amount) that could suffice as a factual allegation. The statement also gives no indication of whether "early 2004" refers to a period before or after January 28, 2004. The allegations that Nokia and Cisco cut orders with Merix "in early 2004" or "in the third fiscal quarter 2004" do not disclose how substantial such cuts were, what proportion of Merix's overall sales they constituted, or whether they occurred before January 28, 2004. W-1's claim that Merix experienced an "abrupt" decline in orders indicates a sudden decline, but does not state how large the decline was or how long it lasted. Likewise there is nothing in the complaint which creates an inference that the number of "flats" in a "typical" order corresponds to the size or number of orders.

While it would be improper to view each of these allegations in isolation, neither can "[c]obbling together a litany of inadequate allegations . . . render those allegations particularized in accordance with Rule 9(b)." *Cal. Pub. Employees' Ret. Sys. v. Chubb Corp.*, 394 F.3d 126, 155 (3d Cir. 2004). In this instance, the sum of

Plaintiff's allegations does not create an inference that the Prospectus misleadingly omitted facts related to a material decline in Merix's demand prior to January 28, 2004.

More fundamentally, none of these allegations renders the statements in the Prospectus false or misleading. Even if Merix experienced cancelled orders from certain customers — or even a general decline in orders — this would not render false the Prospectus' statements that Merix's second quarter 2004 net sales were 43% greater than its second quarter 2003 net sales; that "[u]nit shipments were 47% higher in the second quarter of fiscal 2004 compared to the same period in the prior year;" that "[u]nit shipments were 55% higher in the first six months of fiscal 2004 compared to the first six months of fiscal 2003;" or that "[t]he increase in volume was the result of increased end market demand as well as new program gains from existing customers and the addition of new customers." Likewise these allegations of cancelled orders by some customers, and even a general slowdown in orders placed, fail to render false the statements in the Prospectus claiming that Merix had an "expanding customer base" and had "added a significant number of new customers and many new programs with existing customers."

**b. Cisco**

Plaintiff's allegations that the Prospectus' statements regarding demand were false or misleading for having failed to disclose a decline in

orders from Cisco is similarly deficient. First, the complaint contains no allegation that Cisco's cancellation of orders occurred before the Prospectus issued. Plaintiff relies on W-3's recollection that Cisco delayed and cancelled numerous quick-turn prototype orders "in the third quarter of 2004." The third quarter of Merix's 2004 fiscal year runs through February 2004. Because Plaintiff fails to allege that Cisco's delays and cancellations of orders occurred before the Prospectus issued, Plaintiff has not explained why the statements in the Prospectus were false when made.

Even if Plaintiff had alleged that Cisco began cancelling orders before the Prospectus issued, it is not clear what statement in the Prospectus that fact would render false. The complaint cites paragraphs of the Prospectus which: (1) refer to Cisco as one of Merix's "five largest OEM customers for the first six months of fiscal 2004;" (2) state that "[s]ales attributed to [Merix's] five largest OEM customers comprised 67% and 59% of [Merix's] net sales in the second quarters of fiscal 2004 and 2003, respectively, and 68% and 60% of [Merix's] net sales in the first six months of fiscal 2004 and 2003, respectively;" and (3) state that Merix expected "to continue to depend upon a small number of customers for a significant portion of [its] sales for the foreseeable future." None of these statements is rendered false by Plaintiff's allegation that Cisco delayed and cancelled numerous quick-turn prototype orders in the third quarter of 2004.

Finally, the allegation that Cisco delayed or cancelled "numerous" quick-turn prototype orders fails to state with particularity the approximate number of orders cancelled or delayed, the size of those orders, or what proportion of Merix's business they constituted. Although Cisco was an important customer for Merix, Plaintiff has not pled with particularity sufficient facts to create an inference that the alleged decline in Cisco orders rendered the statements in the Prospectus regarding demand false or misleading.

**5. Merix's financial results showed an increase in revenues and gross margins, in part, because Merix managed its earnings by improperly deferring expenses and shipping defective merchandise.**

A plaintiff pleading irregularities in revenue recognition should allege "(1) such basic details as the approximate amount by which revenues and earnings were overstated; (2) the products involved in the contingent transaction; (3) the dates of any of the transactions; or (4) the identities of any of the customers or [company] employees involved in the transactions." *In re Daou Sys.*, 411 F.3d at 1016 (internal quotation and citation omitted). Although a complaint need not allege each of those particular details, it must state sufficient facts to allow the court to determine whether the alleged irregularities "were minor or technical in nature, or whether they constituted widespread and

significant inflation of revenue." *Id.* at 1017. The plaintiff must show with particularity how the irregularities "affected the company's financial statements and whether they were material in light of the company's overall financial position." *Id.*

In support of its allegation that the Prospectus was misleading because it failed to disclose that Merix improperly deferred expenses, Plaintiff relies on statements from a series of confidential witnesses attesting to lapses in Merix's quality control. As described below, these allegations, taken together, fail to state with particularity facts supporting the existence of the claimed omission.

The complaint states that W-4 claimed that "[b]y 2002 . . . employees were instructed to rush production to expedite the sale, ignoring quality assurance requirements." Compl. at ¶100. W-4 does not state that this practice occurred during the Class Period, that it resulted in shipments of defective products, that it resulted in returns from customers, that any such returns resulted in inflated revenues or gross margins, or that any such inflation was material. Likewise W-4's statement that "on more than one occasion during the Class Period, Motorola returned entire orders because every board had a defect" does not indicate on how many occasions this occurred, how large the orders were, whether they were material to Merix's financial health, or whether they resulted in an improper, material increase in reported revenues or gross margins. *Id.* at ¶103.

Plaintiff cites W-5 for the propositions that quality assurances were routinely ignored and that, as a result, "boards were 'often' sent to customers that were likely to be returned." *Id.* at ¶106. In addition to the lack of particulars in these allegations, the complaint provides no basis for inferring that these problems occurred during the Class Period. Indeed, it is not clear from the complaint how much of the Class Period W-5 worked at Merix, given that he left Merix in "late 2003." *Id.* at ¶104. While the allegation that "during the Class Period, there were three times as many expeditors as individuals in final audit" expressly alleges that this occurred during the Class Period, *Id.* at ¶105, this allegation does not support an inference that this practice resulted in returns or inflated revenues or gross margins, or that any such inflation was material.

In September 2003, W-6 allegedly observed expeditors rushing orders, noted that orders requiring a 100 percent quality check were only spot-checked, and recalled being instructed to ignore certain quality assurance tests and overlook visible defects in products. *Id.* at ¶109-110. W-8 alleges he witnessed pressure to ship orders in order to meet sales targets, including "numerous instances" in which his superiors instructed him to ship defective boards to the customer. *Id.* at ¶118-119. Again, these allegations do not support an inference that these practices occurred during the Class Period, that they resulted in returns or inflated revenues or gross margins, or that any such inflation was material.

Plaintiff's allegations that the Prospectus contained affirmative misrepresentations regarding quality control fail for the same reasons. Plaintiff alleges that the Prospectus falsely stated: (1) that Merix's Forest Grove facility was "certified under the ISO 9002 quality assurance model . . . [which] requires that we meet standards related to management, production and quality control, among others;" (2) that Wood Village would be operated under the same model; and (3) that Merix "use[s] total quality management systems to meet the highest industry standards for product quality." Plaintiff does not allege with any particularity that the Forest Grove facility was not in fact "certified under the ISO 9002 quality assurance model." As set forth above, Plaintiff's allegations regarding defects are not alleged with sufficient particularity to show that the statements that Merix "use[s] total quality management systems to meet the highest industry standards for product quality," or that Wood Village would use the same model, are false.

Taken together, Plaintiff's allegations do not plead with particularity that Merix manipulated its earnings to reflect increased revenues and gross margins.

**6. Merix's glowing outlook was untenable and incomplete for the reasons cited above.**

This allegation is based on the alleged false statements and omissions discussed above. Because these allegations are insufficient even when considered together, Plaintiff's allegation that the

Prospectus misleadingly communicated a false glowing outlook cannot form the basis of Plaintiff's claim.

In sum, the complaint fails to identify with particularity which specific statements in the Prospectus are allegedly false or misleading. In addition, the complaint fails to explain with particularity facts sufficient to create an inference that the claimed omissions rendered statements in the Prospectus misleading when made. Plaintiff's claims against the Underwriter Defendants are therefore dismissed without prejudice.

**C. Standing for Section 12 claims**

The Underwriter Defendants move to dismiss Plaintiff's Section 12(a)(2) claim against them to the extent it is brought on behalf of anyone other than investors who purchased Merix securities directly from the Underwriter Defendants pursuant to the Prospectus. Plaintiff does not dispute that, to bring a claim under Section 12(a)(2), Plaintiff "must have purchased [its] securit[ies] directly from the issuer of the prospectus." *Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076, 1081 (9th Cir. 1999). Plaintiff argues, however, that Defendants' motion is premature, and that these issues are more appropriately addressed at the class certification stage.

Standing is a jurisdictional prerequisite that courts are bound to address at the threshold of a case. *Hickman v. Block*, 81 F.3d 98, 101 (9th Cir. 1996); *see also Nordyke v. King*, 319 F.3d 1185,

1192 (9th Cir. 2003) ( *citing Ex parte McCardle*, 74 U.S. (7 Wall.) 506, 514, 19 L. Ed. 264 (1868) ("Without jurisdiction the court cannot proceed at all in any cause. Jurisdiction is the power to declare the law, and when it ceases to exist, the only function remaining to the court is that of announcing the fact and dismissing the cause.")). Accordingly it is not only appropriate but necessary for the court to consider Plaintiff's standing at the outset of this action.

Plaintiff seeks to represent a class of investors who purchased Merix securities beginning in October 2003, and continuing through May 13, 2004. Neither the investors who purchased shares prior to the issuance of the January 28, 2004 Prospectus, nor those who purchased shares in the aftermarket following the issuance of the Prospectus, have standing to bring suit against the Underwriter Defendants under Section 12(a)(2). Plaintiff's claim under that section is therefore dismissed with prejudice to the extent it is brought on behalf of these investors.

## IV. Conclusion

For the foregoing reasons, Defendants' motions to dismiss Plaintiff's complaint (# 47 and 49) are GRANTED, and Plaintiff's complaint is dismissed without prejudice. Plaintiff's claim under Section 12(a)(2) against the Underwriter Defendants is dismissed with prejudice to the extent it is brought on behalf of investors who did not purchase Merix securities directly from these Defendants pursuant to the Prospectus. Merix's

motion for judicial notice is DENIED as moot, with leave to re-file.

IT IS SO ORDERED.

DATED this 15th day of September, 2005.

/s/ Michael W. Mosman
MICHAEL W. MOSMAN
United States District Judge

**APPENDIX "D"**

[Filed June 24, 2008]

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

| | |
|---|---|
| In re: MERIX CORPORATION SECURITIES LITIGATION | No. 06-35894 |
| CENTRAL LABORERS PENSION FUND,<br>Plaintiff-Appellant,<br>v.<br>MERIX CORPORATION; MARK HOLLINGER; JANIE S. BROWN; ANAYA K. VARDYA; DANIEL T. OLSON; KIRBY DYESS; CARLENE ELLIS; DONALD JOBE; GEORGE KECKHOVE; WILLIAM LATTIN; WILLIAM McCORMICK; ROBERT STRANDBERG; UBS SECURITIES LLC; THOMAS WEISEL | D.C. Nos.<br>CV-04-00826-MO<br>CV-04-00859-MO<br>CV-04-00860-MO<br>CV-04-00931-MO<br>District of Oregon, Portland<br><br>ORDER |

PARTNERS LLC;
NEEDHAM &
COMPANY, INC.;
WELLS FARGO
SECURITIES, LLC;
RAYMOND JAMES &
ASSOCIATES, INC.;
WILLIAM BLAIR &
COMPANY, LLC,

Defendants-Appellees

Before: RYMER, T.G. NELSON, and PAEZ, Circuit Judges

The panel majority has voted to deny the Appellees' joint petition for panel rehearing; Judge Paez votes to deny the Appellees' joint petition for rehearing en banc and Judge Nelson so recommends. Judge Rymer votes to grant the petition for panel rehearing and the petition for rehearing en banc.

The full court has been advised of the petition for rehearing en banc and no active judge has requested a vote on whether to rehear the matter en banc. Rule 35, Federal Rules of Appellate Procedure.

The petitions for panel rehearing and rehearing en banc are DENIED.

## APPENDIX "E"

**Section 11, Securities Act of 1933, 15 U.S.C. § 77k — Civil liabilities on account of false registration statement**

**(a) Persons possessing cause of action; persons liable**

In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue —

(1) every person who signed the registration statement;

(2) every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;

(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;

(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent

been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;

(5) every underwriter with respect to such security.

If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

**(b) Persons exempt from liability upon proof of issues**

Notwithstanding the provisions of subsection (a) of this section no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof —

(1) that before the effective date of the part of the registration statement with respect to which his liability is asserted

(A) he had resigned from or had taken such steps as are permitted by law to resign from, or ceased or refused to act in, every office, capacity, or relationship in which he was described in the registration statement as acting or agreeing to act, and

(B) he had advised the Commission and the issuer in writing that he had taken such action and that he would not be responsible for such part of the registration statement; or

(2) that if such part of the registration statement became effective without his knowledge, upon becoming aware of such fact he forthwith acted and advised the Commission, in accordance with paragraph (1) of this subsection, and, in addition, gave reasonable public notice that such part of the registration statement had become effective without his knowledge; or

(3) that

(A) as regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or

necessary to make the statements therein not misleading; and

(B) as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert,

(i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or

(ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert; and

(C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) or purporting to be a copy of or extract from a report or valuation of an expert (other than himself), he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration

statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert; and

(D) as regards any part of the registration statement purporting to be a statement made by an official person or purporting to be a copy of or extract from a public official document, he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue, or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement made by the official person or was not a fair copy of or extract from the public official document.

**(c) Standard of reasonableness**

In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.

**(d) Effective date of registration statement with regard to underwriters**

If any person becomes an underwriter with respect to the security after the part of the registration statement with respect to which his liability is asserted has become effective, then for the purposes of paragraph (3) of subsection (b) of

this section such part of the registration statement shall be considered as having become effective with respect to such person as of the time when he became an underwriter.

**(e) Measure of damages; undertaking for payment of costs**

The suit authorized under subsection (a) of this section may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and

(1) the value thereof as of the time such suit was brought, or

(2) the price at which such security shall have been disposed of in the market before suit, or

(3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought: Provided, That if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages

shall not be recoverable. In no event shall any underwriter (unless such underwriter shall have knowingly received from the issuer for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting) be liable in any suit or as a consequence of suits authorized under subsection (a) of this section for damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public. In any suit under this or any other section of this subchapter the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit or the defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him, in connection with such suit, such costs to be taxed in the manner usually provided for taxing of costs in the court in which the suit was heard.

**(f) Joint and several liability; liability of outside director**

(1) Except as provided in paragraph (2), all or any one or more of the persons specified in subsection (a) of this section shall be jointly and severally liable, and every person who becomes

liable to make any payment under this section may recover contribution as in cases of contract from any person who, if sued separately, would have been liable to make the same payment, unless the person who has become liable was, and the other was not, guilty of fraudulent misrepresentation.

**(2)**

**(A)** The liability of an outside director under subsection (e) of this section shall be determined in accordance with section 78u–4 (f) of this title.

**(B)** For purposes of this paragraph, the term "outside director" shall have the meaning given such term by rule or regulation of the Commission.

**(g) Offering price to public as maximum amount recoverable**

In no case shall the amount recoverable under this section exceed the price at which the security was offered to the public.

## APPENDIX "F"

**Section 12, Securities Act of 1933, 15 U.S.C. § 77l — Civil liabilities arising in connection with prospectuses and communications**

**(a) In general**

Any person who —

(1) offers or sells a security in violation of section 77e of this title, or

(2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraphs (2) and (14) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable, subject to subsection (b) of this section, to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest

thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

**(b) Loss causation**

In an action described in subsection (a)(2) of this section, if the person who offered or sold such security proves that any portion or all of the amount recoverable under subsection (a)(2) of this section represents other than the depreciation in value of the subject security resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statement not misleading, then such portion or amount, as the case may be, shall not be recoverable.

## APPENDIX "G"

**Section 15, Securities Act of 1933, 15 U.S.C. § 77o — Liability of controlling persons**

Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

## APPENDIX "H"

**Federal Rule of Civil Procedure 9(b)**

**Fraud or Mistake; Conditions of Mind.** In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally.